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PRO-ACTIVE ACCOUNTING ACTIVITIES IN EUROPE (PAAinE)

DISCUSSION PAPER

THE FINANCIAL REPORTING OF PENSIONS

JANUARY 2008

The financial reporting of pensions

A PAAinE Discussion Paper

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This paper is part of Europe's 'Pro-active Accounting Activities in Europe' (PAAinE) initiative, which is a partnership between the European Financial Reporting Advisory Group ('EFRAG') and European standard-setters.

The development of this paper has been led by the Accounting Standards Board ('ASB'), in collaboration with EFRAG. The paper is issued by:

- *the ASB, the UK standard-setter;*
- *EFRAG;*
- *the Conseil National de la Comptabilité (CNC), the French standard-setter;*
- *the Accounting Standards Committee of Germany (ASCG)(Deutsches Rechnungslegungs Standards Committee (DRSC), the German standard-setter; and*
- *the Organismo Italiano di Contabilità(OIC), the Italian standard-setter.*

The paper has been approved by the Co-ordinating Group of PAAinE, which comprises representatives of the issuers and standard-setters of The Netherlands, Poland, Spain, and Sweden.

The views set out in the paper reflect the preliminary views of the ASB and will be reconsidered in the light of responses. The other bodies named above do not express any opinion on these views at this stage.

The paper is available for downloading from the websites of the issuers. A limited number of copies will also be available in printed form.

Comments on any aspect of this paper are invited by 14 July 2008. Comments may be sent, preferably by e-mail to:

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For the convenience of those preparing comments, the questions highlighted in the Invitation to Comment may be downloaded (in word format) from the ASB's website.

About the PAAinE

EFRAG and the European National Standard Setters have agreed to pool some of their resources and work together more closely so that Europe as a whole can participate more effectively in the global accounting debate. It was agreed that this initiative should in the beginning concentrate on long-term pro-active work. The objective of the initiative is to stimulate debate on important items on the IASB agenda at an early stage in the standard-setting process before the IASB formally issues its proposals. The initiative has the joint ambitions of representing a European point of view and exercising greater influence on the standard-setting process. This initiative is known as the 'Proactive Accounting Activities in Europe' (or PAAinE) initiative.

Work carried out under the PAAinE initiative can take a number of different forms and the full objectives of the initiative are:

- to stimulate, carry out and manage pro-active development activities designed to encourage the debate in Europe on accounting matters and to enhance the quality of the pro-active input to the IASB;
- to co-ordinate and resource monitoring work of IASB and FASB projects; and
- to try to ensure, as far as is practicable, that the messages Europe gives the IASB are consistent.

A further description of the PAAinE initiative and its various projects are available on the EFRAG website (www.efrag.org).

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Preface

1 The International Accounting Standards Board ('IASB') and the United States Financial Accounting Standards Board ('FASB') are committed to a long-term review of the financial reporting of pensions. The objective of this paper is to take a fresh look at – and stimulate discussion on – the principles that might be reflected in future accounting standards on pension benefits that are related to employment. The development of this paper has been led by the UK Accounting Standards Board (ASB) as part of Europe's 'Pro-active Accounting Activities in Europe' (PAAinE) initiative that is a partnership including the European Financial Reporting Advisory Group ('EFRAG') and European standard-setters. The views presented are the preliminary views of the ASB; EFRAG and the other European standard-setters do not express any opinion on these at this stage.

2 In economies in which pension obligations are significant, it is important that there is a high degree of confidence in the financial reporting of pensions by employers and by pension plans. However, the financial reporting of pensions has recently been the subject of significant controversy. The pension deficits of many companies have attracted much comment, particularly in the context of corporate transactions (e.g. takeovers and disposals) and share valuations. (At other times, comment has focused on pension surpluses and the associated contribution holidays.) Major changes have been made both in respect of the pension benefits provided by employers and in the type of investments that are held by pension plans. In some countries, the regulatory framework for pensions has been reformed, resulting in significant changes in the relationship between a sponsoring employer and its pension plan.

3 The accounting framework has also changed. For example, many companies have adopted International Financial Reporting Standards ('IFRS'), including IAS 19 'Employee Benefits'. This standard requires deficits or surpluses in pension plans to be reflected in the employer's financial statements and provides a number of options for achieving this. This may have focused attention on the financial implications of pension arrangements, and thus have played a part in some of the developments referred to above. Some have criticised accounting standards for promoting changes which they see as undesirable; others whilst agreeing that recent developments in pensions accounting have improved financial reporting have suggested that it is possible to make further progress in reducing the number of options and enhancing the quality of the information provided.

4 It is clear that the financial reporting of pensions continues to be a matter of concern world-wide and that part of the problem is that the accounting models developed 20 or 30 years ago are based on a simplistic view of pension arrangements and no longer adequately reflect the range of arrangements that now exist.

5 Standard-setters have responded, but so far only in a limited way:

- The IASB is undertaking a project that will address a limited number of topics in its first phase, aiming to issue an improved standard by 2011. The topics include:

- the accounting for pension plans that contain defined return promises;
 - the elimination of options to avoid or defer recognising deficits or surpluses in pension plans; and
 - the presentation of gains and losses arising from changes in pension liabilities and, where applicable, assets that back them.
- The FASB has issued (in September 2006) SFAS 158 'Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans' which amends SFAS 87 'Employers' Accounting for Pensions' to require deficits or surpluses in pension plans to be recognised in employers' balance sheets;
 - The FASB has announced a second phase to its project that will focus principally on presentation of assets, liabilities and the cost of providing post-retirement benefits, and disclosure;
 - The ASB has issued amendments to its standard FRS 17 'Retirement Benefits', aligning its disclosure requirements with those of IAS 19 and publishing a Reporting Statement 'Retirement Benefits – Disclosures' that recommends further disclosures that would usefully supplement those required by accounting standards;

6 The aim of the present discussion paper is rather different from these initiatives. Rather than seeking to improve existing accounting standards, it represents a fundamental reconsideration, starting from first principles, of the accounting that should be required for pensions. The paper sets out views that could form the basis for proposals for future accounting standards. Some of the views in the paper differ markedly from existing standards on pensions: for example, the view that the same principles should be applied to all pension arrangements, whether 'defined contribution' or 'defined benefit' plans, and the view that the expected return on assets should not be reported as part of the profit or loss for the year.

7 It is not sensible to consider the financial reporting of pensions without close regard to the current state of accounting thinking on other subjects. Accordingly the views set out in this paper have been informed by IASB's *Framework for the Preparation and Presentation of Financial Statements* and recently issued standards and proposals for revision of the Framework and the standards. Many of the views put forward in this paper reflect the belief that financial reporting for pensions would be significantly improved by applying the same solution as that used elsewhere in financial reporting. However, for various reasons pensions give rise to challenges for financial reporting. These include the great uncertainties that often affect the amount of pension benefits, the very long time over which they are paid and the complex arrangements for funding them that exist in many countries. Thus in those instances where it appears that high quality financial reporting for pensions requires principles that are used elsewhere in financial reporting to be extended or modified, such approaches are considered. Moreover,

the principles used elsewhere are currently evolving – for example, there is not yet a single solution in financial reporting to the measurement of liabilities.

8 As this paper is framed in the context of current accounting thinking, it assumes that balance sheets will continue to be prepared, showing the financial position at a point in time and that any liability in respect of pensions will be included in the balance sheet as a single figure. But it is frequently observed that, for something as complex and significant as a pension liability, no single measure can provide useful information for all purposes. The paper therefore explores ways in which the significance of the most appropriate measure of a pension liability can be explained and put into context by supplementary disclosures.

9 Recent concerns have not been limited to the effect of pension obligations on employers. There has also been concern as to the value and security of pensions to current and future pensioners. Accounting has a part to play in ensuring that pension plan members are informed of the plan's financial position. It may be noted that IAS 26 'Accounting and Reporting by Retirement Benefit Plans' is more than twenty years old, and it seems reasonable to question whether it reflects current accounting thinking. This paper therefore also sets out views on the financial reporting by pension plans, focusing on the general purpose financial statements that a plan might prepare.

10 Comments on this Discussion Paper are invited. The comments will be analysed, and in the light of this analysis recommendations will be made in a published report, which will provide input to the IASB and the FASB in the long-term review of pension accounting to which both boards are committed.

Contributors

The ASB would like to record, on behalf of itself and of PAAinE, its thanks for the significant contribution to this paper made by the following individuals. The persons indicated with an asterisk are the principal authors of significant parts of the paper.

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Summary and Invitation to Comment

The following summary sets out the main points that are discussed in this paper.

Whilst comments are welcome on any aspect of the views expressed in this paper, the summary highlights some specific questions on which comments would be particularly welcome. These questions are printed in *bold italic text*.

Comments will be most helpful if they indicate the part of the paper to which they relate and explain the rationale for the comment made.

Comments are requested by 14 July 2008.

Chapter 1: Introduction

S1 This paper sets out views on how pension arrangements including the obligation to provide pensions (including lump sums payable at or near retirement) are best reflected in financial statements. It considers both the financial statements of the employer and those of a pension plan.

S2 Although the underlying principles might be expected to be similar for all long-term benefits, this paper focuses on pensions.

S3 One of the perceived difficulties with existing pension standards is that they draw a sharp distinction between defined contribution and defined benefit plans. This is particularly troublesome when, as is increasingly the case, pension plans have elements of both types. The paper takes the approach of considering the fundamental principles, which should be common to all pension plans.

Chapter 2: Liabilities to pay benefits

S4 Liabilities, as defined in the *Framework* arise when there is a present obligation to transfer economic benefits. This Chapter sets out views on which possible future pension benefits are (or are not) present obligations and should therefore be (or not be) reflected in the reported liability to provide pension benefits.

S5 Pension obligations arise under employment contracts in which pension benefits are provided in exchange for services. It is at the time at which services are provided that a liability arises. (Paragraphs 3.1-3.12)

S6 The liability that arises when service is provided includes, in addition to vested benefits, benefits in respect of services provided before vesting, because an employer cannot realistically avoid his promise (or can cancel it only on payment of compensation). (Paragraphs 3.13-3.30)

S7 The liability that arises is often subject to a number of uncertainties, including those relating to future prices and other economic factors and demographic factors such as mortality: many of these clearly are relevant to the measurement of a liability, not whether it exists. (Paragraph 2.15)

S8 It is less clear whether some other factors, including benefits that the employer has discretion to vary and the level of future pensionable salaries, concern the measurement of a liability or its existence. There should be a clear principle that provides a basis for determining whether an entity has a liability for benefits that it might become committed to in the future: (Paragraph 2.16)

- Some believe all expected payments in relation to past service, including benefits that the entity might become committed to in the future, should be reflected in the liability. (Paragraphs 4.16-4.17)
- This paper concludes that only benefits that the entity is presently committed (by legal or constructive obligation) to pay should be reflected in the liability. (Paragraphs 4.18-4.24)

S9 Consequently, a liability in respect of pensions includes increases that are guaranteed by law or contract, and also those that an entity has a constructive obligation to provide. However, only benefits to which the entity is presently committed 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 reported liability should also not reflect possible future changes to the entity's or the plan's financial position. (Paragraphs 4.4-4.12; 4.25-4.30)

S10 For benefit designs that link the amount of benefits to the employees' salaries at or near retirement or leaving service, the requirement to include the effect of expected future salary increases in the liability that is recognised during service should be reconsidered. Alternative views have coalesced around two positions: (Paragraphs 4.31-4.63)

- Some believe that the liability to pay benefits that is recognised (and the pension expense for each period) should be based on expectations of employees' pensionable salaries when they leave service.
- Others (including a majority of the ASB's members) believe that the liability to pay benefits that is recognised (and the pension expense for each period) should be based on the benefits that the employer is presently committed to provide – this would usually be benefits based on current salaries plus any increases that are required by law or contract and would include other increases that are seen as non-discretionary, i.e. in respect of which there is a constructive obligation. Under this view, the pension expense of each period will reflect the extra pension liability incurred by giving increases in pensionable salaries.

Q1 *Should a liability to pay benefits that is recognised be based on expectations of employees' pensionable salaries when they leave service, or on current salaries (including non-discretionary increases)?*

S11 An issue in considering the liabilities that arise in the context of pensions is the unit of account: should financial reporting be based on the premise that a liability is owed to an individual employee or to the workforce as a whole? It may be reasonably clear that an employer can realistically avoid incurring an obligation, such as that for future salary increases, to an individual employee, but doubtful whether the employer can realistically avoid it for the entire workforce. (Section 5)

Q2 *Should financial reporting be based on the premise that a liability is owed to an individual employee or to the workforce as a whole? What consequences do you consider your view has for the recognition and measurement of pension obligations?*

S12 The present requirements for attributing benefits to periods of service in defined contribution plans and defined benefit plans are unsatisfactory because there is no clear principle behind them that can be applied consistently across the spectrum of benefits. The focus should shift from mechanisms that spread pension costs over employees' service lives to the principle of reflecting only present obligations as liabilities. (Section 6)

Q3 *Do you agree that recognition should be based on the principle of reflecting only present obligations as liabilities?*

Chapter 3: Assets and liabilities: reporting entity considerations

S13 This Chapter considers how obligations to provide pension benefits and assets held to pay such benefits should be reflected in the financial statements of an employer and of a pension plan. It considers an employer's individual and consolidated financial statements.

Individual financial statements

S14 If the employing entity is directly responsible for paying the benefits promised to employees, the liability must rest directly with the employing entity. (Paragraphs 2.4-2.6)

S15 Where a pension is provided by a third party (such as an insurance company) some or all of the employer's present obligation to the employee is extinguished by transferring assets (i.e. paying agreed contributions) to that third party. (Paragraphs 2.7-2.18)

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S16 Where a fund of assets is established which is not transferred to a separate entity (i.e. it is simply a collection of assets of the employing entity):

- the assets held in the fund are reported as assets of the employing entity in its individual financial statements; and
- the obligation to pay benefits is a liability of the employing entity (i.e. it is not a liability of any other reporting entity).

(Paragraphs 2.23-2.27)

S17 Where assets are transferred from the employer to an employer-sponsored plan:

- If the employer has the legal or constructive obligation to pay benefits, it will have a liability to pay benefits and also an asset, representing its right to reimbursement from the plan. (Paragraphs 2.34-2.38)
- If the plan assumes the obligation to pay benefits and the employer has an obligation to make contributions to the plan to the extent that the plan's obligations cannot be met from its own assets, the asset or liability that is properly representative of the employer's rights and obligations is a net asset or liability that reflects its right to benefit from a surplus or its obligation to contribute to a deficit. (Paragraphs 2.39-2.42)

S18 The reasons for the present requirement of IAS 19 to give a net presentation in some circumstances where the employer has a direct obligation to pay benefits do not seem to be convincing and should be reconsidered. A gross presentation would appropriately reflect the economic substance and be consistent with accounting principles that are applied elsewhere. (Paragraphs 2.43-2.46)

The employer's consolidated financial statements

S19 There is no conceptual reason why financial reporting standards should provide an exemption from the consolidation of pension plans. Where a pension plan is part of a single economic entity (the group) then the usefulness of the information in the employer's financial statements is improved if the pension plan is consolidated. (Paragraphs 3.3-3.22)

S20 Where it is determined that an entity does have control of the plan then consolidation of the plan will result in the assets and liabilities of the plan being presented "gross" in the employer's consolidated financial statements. (Paragraphs 3.14-3.22)

S21 The notion of control (based on whether the employer has rights over the plan's assets and liabilities which give it access to the benefit of those assets and liabilities and the ability to increase,

maintain or protect the amount of those benefits) provides a suitable means to determine whether a plan should be consolidated. (Paragraphs 3.23-3.35)

S22 Control may arise where the employer has the decision making powers of the plan and can direct managers/(trustees) of the pension plan or can determine investment, funding or benefit policy. Determination of this will require consideration of all relevant factors, including regulatory influences, and be based on the substance of the relationship between the employer and the pension plan. (Paragraphs 3.36-3.71)

S23 The application of the notion of control would result in some pension plans being consolidated into the group financial statements – whereas other plans an entity participates in might not be consolidated. It might be argued that this gives rise to inconsistency. However, if the criteria for consolidation are founded on appropriate principles, then the accounting treatment would reflect the economic substance of the relationship between the entity and all its plans. (Paragraph 3.75)

Q4 Do you agree that the consolidation of pension plans should be subject to the same principles as are usually applied in determining whether consolidation is appropriate?

Chapter 4: Recognition of pension assets and liabilities

S24 Under current standards, changes in the measurement of assets and liabilities relating to pension plans may be deferred, that is recognised prospectively over a period, such as the average remaining service lives of employees. Or a ‘corridor’ approach may be used, under which changes are not recognised at all unless they exceed a certain threshold.

S25 Having considered the arguments that support these approaches, the paper concludes that they do not provide sufficient justification for the balance sheet to portray assets and liabilities relating to pensions plans in a manner that is not representationally faithful. Accordingly, accounting standards should not permit these approaches, and all changes should be recognised immediately.

Q5 Do you agree that changes in assets and liabilities relating to pension plans should be recognised immediately, rather than deferred and recognised over a number of accounting periods or left unrecognised provided they are within certain limits (a ‘corridor’) approach?

Chapter 5: Measurement of liabilities to pay benefits

S26 The views in this Chapter may be summarised as follows:

- A liability in respect of future pensions should be measured at a current value. (Section 3)

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- A current value measure will be a 'settlement amount', reflecting a measure of the cash outflows (or other transfers of economic benefits) needed now or in the future to discharge the liability. (Section 4)
- If alternative means of settling a liability are currently available to an entity (i.e. it is within the employer's control to achieve them), the liability should be reported at the lowest amount of the available alternatives. (Section 5)
- Regulatory measures of liabilities to pay pensions should not replace measures derived from general accounting principles. (Paragraphs 6.7-6.19)
- The objective of a current value measure of future payments of pension benefits is to reflect today's value of the future cash outflows expected to settle the liability when it falls due. This approach might be viewed as an 'entity-specific' measurement, because it aims to reflect not only the properties of the liability itself but also the relationship to its owner. Where this measure is derived from discounting future cash flows it should reflect:
 - expected value of cash flows (entity's best estimates) that would be admitted under the proposals in Chapter 2
 - current market discount rate to reflect the time value of money only, i.e. a risk-free rate.

(Paragraphs 6.20-6.41)

- In theory the liability should also reflect a margin for risk, but there is concern that some risks (for example, those relating to future changes in mortality) are 'unknowable' and therefore cannot be quantified. Accordingly, users are better served by disclosure about the sensitivities of the liability to changes in the assumptions that have been used in arriving at the best estimates. (Paragraphs 6.42-6.52)
- It is inappropriate for an entity's liability for pensions to be reduced to reflect its credit risk. (Section 7)
- Measurement of the liability should reflect expenses of administering the plan's accrued benefits. (Section 8)

Q6 *Do you agree with the paper's views in the measurement of liabilities to pay benefits? In particular, do you agree that:*

- *Regulatory measures should not replace measures derived from general accounting principles?*

- *The discount rate should reflect the time value of money only, and therefore should be a risk-free rate?*
- *Information about the riskiness of a liability (i.e. the risk that the amount of pension benefits will differ from today's expectations) is best conveyed by disclosure rather than by adjusting the amount of the reported liability?*
- *The liability should not be reduced to reflect its credit risk?*
- *Expenses of administering the plan's accrued benefits should be reflected in the liability?*

S27 An issue that arises is how *employees'* options regarding settlement should be viewed. One possibility is that the employer should report a liability that is based on the highest amount, until the employee elects to receive a lower amount. Another possibility is that the employer should report a liability that reflects the probability of different outcomes. (Paragraphs 5.15-5.17)

Q7 *Where employees have options to receive benefits in different ways, should the liability be reported at the highest amount or at an amount that reflects the probability of different outcomes ?*

Chapter 6: Measurement of assets held to pay benefits

S28 This Chapter advances the following views on the measurement of assets held to pay benefits:

- Reporting assets held to pay benefits at current values provides more useful information than reporting them at historical measures. This is consistent with the views presented on measuring liabilities to pay benefits. (Paragraphs 3.2-3.3)
- The present requirement in pensions accounting standards that assets traded in active markets are measured at market values is well founded. (Paragraphs 3.10-3.13)
- The role of investment strategy in meeting obligations to pay benefits requires explanation (rather than recognition) in financial statements. (Paragraphs 3.19-3.23)
- When an asset is not traded in an active market, a current value should be estimated using a valuation technique in accordance with the guidance in other accounting standards. (Paragraphs 3.24-3.31)

Q8 *Do you agree that assets held to pay benefits should be reported at current values?*

Chapter 7: Measurement of employer interests in assets and liabilities of trusts and similar entities

S29 This Chapter discusses the measurement of assets and liabilities shown in the sponsoring employer's financial statements when a separate trust or similar entity is established to hold assets to pay benefits. It concludes that:

- If the employer has a direct obligation to pay benefits and a right to be reimbursed by a trust, its right to reimbursement should be measured on the same basis as the underlying assets held by the trust. (Section 3)
- If the contractual arrangements result in a 'net' asset or liability being representative of the employer's rights and obligations, the measurement of the net amount should be based on the difference between the amounts at which the assets and liabilities would be measured if they were measured directly, subject to reflecting the effect of any restrictions on the assets. (Section 4)

Q9 Do you agree that a 'net' asset or liability should be based on the difference between the amounts at which the assets and liabilities would be measured if they were measured directly?

Chapter 8: Presentation in the financial statements

S30 This Chapter considers how changes in the pension liabilities and in the assets held to fund those liabilities should be reported in the financial performance statement. It does not seek to address all the questions that are currently being debated in the context of financial statement presentation (such as whether measures of earnings should be presented), but builds on the requirements of IAS 1 (revised September 2007) 'Presentation of Financial Statements', and notes that current work by the IASB and FASB is considering a distinction between business and financing activities. It assumes that in the future statements of financial performance will provide separate disclosure of the following:

- Operating activities;
- Financing; and
- Other financial performance

(Section 2)

S31 The paper considers the view that changes in liabilities and/or assets for a period should not be disaggregated, but favours an approach under which different components of the expense are presented separately (even where a 'net' asset or liability is reported in the balance sheet), as different components seem to have different drivers and predictive value. (Section 3)

Q10 *Do you agree that different components of changes in liabilities and/or assets should be presented separately?*

S32 The paper proposes that the changes in assets and liabilities should be presented as follows:

Service cost—within operating activities (Paragraphs 4.2-4.8)

Finance cost of pensions—within financing (Paragraphs 4.9-4.14)

Effect of change in the discount rate—within financing (Section 6)

Actual return on assets—within financing (Section 5)

Actuarial gains and losses—in the profit and loss account, within other financial performance.
(Section 7)

S33 A notable difference from the requirements of current accounting standards is the proposal that the financial statements should report the actual return on assets, rather than the expected return. However, as users find the expected return on assets useful, it is proposed that it should be disclosed in a note to the financial statements. (Section 5)

Q11 *Do you agree that the financial performance of an entity should reflect the actual return on assets, rather than the expected return, and that the expected return should be required to be disclosed?*

S34 ‘Actuarial gains and losses’ would differ from that arising under present accounting standards because they would not include the effect of changes in the discount rate, nor the difference between the expected and actual return on assets. (Paragraphs 7.1-7.2)

Chapter 9: Disclosures in the employer’s financial statements

S35 This Chapter reviews the disclosures that it would be appropriate for an accounting standard to require.

S36 Disclosures should provide information that explains the risks and rewards arising from the provision of pension benefits, having regard to the materiality of the amounts involved, such that:

- (a) financial statements contain adequate disclosure of the cost of providing pension benefits and any related gains, losses, assets and liabilities;
- (b) users of financial statements are able to obtain a clear view of the risks and rewards arising from liabilities to pay pension benefits and the assets held to fund those benefits; and

- (c) the funding obligations of the entity, in relation to liabilities to pay pension benefits, are clearly identified.

(Section 2)

S37 For practical reasons, an accounting standard would have to permit an employer to provide disclosure of information relating to its plans in aggregate; however, it would be reasonable to require separate information about surpluses and deficits. There is also a case for requiring specific disclosures for individual plans that are material to the group as a whole. (Paragraphs 6.7-6.9)

An Appendix to Chapter 9 provides a summary of the proposed disclosures.

Q12 Do you agree with the objectives of disclosure that are identified in this Chapter? Are there specific disclosure requirements that should be added to or deleted from those proposed?

Chapter 10: Accounting for multi-employer plans

S38 The recognition and measurement principles as set out in Chapters 4-7 of this paper should also apply in relation to multi-employer plans. Accordingly, the pension liability of an individual employer will be a 'settlement amount' reflecting its expected future cash-flows to the plan for settling its obligation for its former and current employees and any constructive obligation in respect of its share in the current under- or over-funding of the plan.

S39 The following alternative approaches are considered as a surrogate for a settlement amount.

- Proportionate share of collective pension asset or liability
- Reflect only the effect of recovery plans or asset refund plans
- Do not account for the employer's rights and obligations in respect of under- or over-funding.

Q13 Do you agree that multi-employer plans should be reflected in an employer's financial statements using the same principles as those that apply to a single employer plan? How, in your view, should an accounting standard require that this be implemented in practice?

Chapter 11: Financial reporting by pension plans

A standard for pension plans

S40 IASB should consider withdrawing IAS 26 'Accounting and reporting by retirement benefit plans'. Requirements for the general purpose financial reports of pension plans should be consistent with IFRS.

(Section 3)

The objective of financial reports of pension plans

S.41 The objective of the financial reports of a pension plan is to provide information about the financial position, performance and changes in financial position of a pension plan that is useful to members and those who act in their interests, in making economic decisions and assessing the stewardship of the trustees. (Section 4)

Assets available to pay benefits

S.42 Assets available to pay benefits should be stated at current value, which is market value where the asset is traded on a market. (Section 5)

Liabilities to pay benefits

S.43 The standard should require a pension plan's financial statements to include the liability to pay future pensions. (Paragraphs 6.4-6.9)

S.44 The components of a plan's liability should be the same as those identified in Chapter 3 (Paragraphs 6.10-6.13). A plan's liability in respect of future pensions should be measured according to the principles identified in Chapter 5. (Paragraphs 6.14-6.19)

Q14 *Do you agree that a pension plan's general purpose financial report should include its liabilities to pay benefits in the future? Do you agree that the plan's liabilities for future benefits should be quantified using the same principles as an employer's liability?*

The employer's covenant

S.45 Where an employer undertakes to make payments to a plan to enable it to pay future benefits, then the plan should recognise an asset, reflecting its claim on the employer, based on the difference between its liability in respect of future benefits and the current value of assets available to pay those benefits. Where necessary, the amount reported as an asset should be reduced to its recoverable amount. (Section 7)

Q15 *Do you agree that a pension plan's statement of financial position should reflect an asset in respect of amounts potentially receivable under an employer's covenant, and that this should reflect the employer's credit risk?*

Other matters

S.46 The standard for financial reports of pension plans should require a minimum content for the financial statements of plans. The required disclosures should be built on those identified in Chapter 9 for the employer and those currently required by IAS 26.

S.47 Further consideration should be given to disclosures (either in the Management Commentary or in the financial statements) in respect of investment strategy; the employer's covenant; and related party transactions. (Section 8)

General questions

S.48 The principles set out in this paper are intended to apply to pension arrangements of all kinds. Although during the development of this paper, care was taken to solicit information on arrangements in various countries, it is possible that there are arrangements of which the authors are unfamiliar that require further consideration.

Q16 *Are there types of pension arrangements that require further consideration? Please identify the specific features of these arrangements and suggest how the principles of this paper would require development to secure appropriate financial reporting for them.*

S.49 The proposals in this paper have been framed with regard to the principle that requirements for financial reporting should not impose costs that are disproportionate to their benefits. However, an assessment of the costs and benefits of improvements in financial reporting is often difficult, particularly at early stages of the development of new ideas.

Q17 *Are there further specific issues relating to the cost and benefit of the proposals that should be taken account of in their further development?*

Chapter 1: Introduction

1 Introduction

A fundamental review

1.1 This paper sets out views on how pension arrangements including the obligation to provide pensions are best reflected in financial statements. It considers both the financial statements of the employer and those of a pension plan.

1.2 The financial reporting of pensions continues to be a matter of concern worldwide. The IASB is undertaking a project that will address a limited number of topics in its first phase, aiming to issue an interim standard which includes improvements to the existing standard IAS 19 'Employee Benefits' by 2011.

1.3 The IASB (and the FASB) are, however, committed to a long-term review of the financial reporting of pensions. This paper is intended to contribute to that review. Therefore, rather than seeking to identify minor improvements to existing accounting standards, it provides a fundamental consideration starting from first principles, of the accounting that should be required for pensions.

1.4 This paper does not, however, attempt to re-write principles used elsewhere in financial reporting – for example, it does not propose new definitions of assets and liabilities, new theories on consolidation or on how gains and losses should be presented in performance statements. Instead, many of the views put forward in this paper reflect the belief that financial reporting for pensions would be significantly improved by applying the same solution as that used elsewhere in financial reporting.

1.5 The views set out in this paper have therefore been informed by IASB's Framework for the Preparation and Presentation of Financial Statements (the Framework), recently issued accounting standards that deal with related topics, and proposals for revision of the Framework and the standards.

General purpose financial reporting

1.6 Moreover, the views set out in this paper are confined to general purpose external financial reporting that is addressed by financial reporting standards. The objective of financial statements as stated in the Framework is "to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions"¹.

1.7 The Framework is, however, currently being revised under a joint project of the IASB and FASB to develop a common conceptual framework. In July 2006 the IASB published a Discussion Paper 'Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of

¹ Paragraph 12.

Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information’, in which it proposes to modify the objective of financial reporting “to provide information that is useful to present and potential investors and creditors and others in making investment, credit and similar resource allocation decisions”. The discussion paper explains that information will help to achieve that objective if it is useful in assessing cash flow prospects, helping users to assess the amounts, timing, and uncertainty of an entity’s future cash inflows and outflows.² The discussion paper considers investors and creditors (and their advisers) to be the most prominent group of external users.

1.8 At the time of writing, the IASB and FASB are reviewing the proposed objective in the light of their consultations. Many, including contributors to this paper, believe that the objective should reflect a wider range of decisions for which investors and creditors (and their advisers) make use of financial statements, in order to give more prominence to financial information that is useful for assessing stewardship. This is particularly relevant to general purpose external financial reporting by pension plans; this paper therefore considers whether the Framework provides a suitable objective for pension plans’ financial statements (see Chapter 11).

1.9 It may also be noted that other stakeholders, including regulators, who are concerned about funding and solvency of pension arrangements, may have different information requirements to the main users of general purpose financial statements.

Financial reporting principles are evolving

1.10 For various reasons pensions give rise to challenges for financial reporting. These include the great uncertainties that often affect the amount of pension benefits, the very long time over which they are paid and the complex arrangements for funding them that exist in many countries. Thus in those instances where it appears that high quality financial reporting for pensions requires principles that are used elsewhere in financial reporting to be extended or modified, such approaches are considered.

1.11 Moreover, the principles used elsewhere are currently evolving. In addition to the review of the Framework, IASB projects are in progress to improve, or review more fundamentally, several accounting standards. The conclusions that emerge from a number of them could be highly relevant to aspects of a future accounting standard on pensions. Matters being addressed in the Framework and other projects include:

- revisions to the definitions of assets and liabilities (the Framework project);
- revisions to the definition and measurement of contingent liabilities and long-term provisions (Revisions to IAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’);
- defining the boundaries of a reporting entity (the Framework project);

² Chapter 1 of the IASB’s Discussion Paper.

- criteria for including assets, liabilities and activities of other entities in consolidated financial statements (the consolidations project);
- accounting for rights and obligations under insurance contracts (insurance project);
- measuring assets and liabilities (fair value measurements project; financial instruments project);
- presentation of information in performance statements (financial statement presentation project);
- financial instruments.

1.12 This paper refers in a number of instances to relatively firm IASB decisions (as evidenced in exposure drafts, IASB Update and website) that would affect the accounting issues under consideration. One effect of this approach is that some of the discussion inevitably relates to emerging proposals that might be changed; nevertheless, we believe that the discussion is more useful if it reflects new thinking where it is relevant than if it relied on the old requirements.

1.13 It is also possible that current or emerging thinking on related topics appears to result in a treatment that is not best suited to pensions arrangements. Where this is the case it might either expose a weakness in that thinking or a reason for pensions to be treated differently. Where we conclude that pensions should be treated differently, it is instructive to understand why that conclusion is reached.

1.14 It is frequently observed that it is not possible to encapsulate all relevant information about the nature of obligations to provide pensions, and the arrangements that may exist for funding them, in the single measures that are reported in a balance sheet, and that any accounting measure can only provide a snapshot of the financial position at a point in time. This paper therefore explores ways in which the most appropriate measures of liabilities and of assets that are held to fund them, as well as the dynamic of the relationship between them, can be explained and put into context by supplementary disclosures.

2 Scope

Pensions

2.1 This project has been undertaken because of concerns about present accounting standards for pensions worldwide. Some consider their deficiencies are so great as to pose a risk to confidence in financial reporting. Although pensions are one of many types of deferred remuneration given in exchange for an employee's services, they are economically the most significant type. Accordingly, the ASB and EFRAG wished to ensure that pensions were the main focus of the project and to avoid addressing too wide a range of issues.

2.2 This paper therefore takes the practical approach of only addressing the accounting for pension benefits that are related to employment. For this purpose, it is believed that the nature of pension benefits is generally understood, covering arrangements that are designed to provide employees (or their dependants) with an income in retirement. Pensions are flexible things, however. As well as regular payments made during retirement, they may include lump sum amounts payable on or after retirement. In some jurisdictions it is also possible for employees to receive some benefits from pension plans whilst remaining in service. Pension benefits are often payable out of a fund to which the employer (and sometimes the employee) has contributed during the employee's working life.³

2.3 This paper frequently uses the term 'pension plan'. In this context, the word 'plan' does not imply any special characteristics in an arrangement but is intended to have the same meaning as when it is used in IAS 19.⁴

Other post-employment benefits

2.4 To the extent that they address other types of post-employment benefits, such as the provision of medical care during retirement, accounting standards treat them similarly to pensions. This is to be expected, because the underlying principles, such as whether there is a liability, are relevant to all types of long-term benefits. However, as noted above, this paper focuses on obligations to provide pensions and does not address obligations to provide other types of benefits.

3 A spectrum of pension benefits

3.1 Existing pensions accounting standards distinguish between defined contribution and defined benefit plans and specify financial reporting requirements for each type.

3.2 Defined contribution plans do not guarantee any value for pension benefits on retirement, and the employer's obligation is confined to making specified contributions. The actual benefits received by the employee are therefore variable and uncertain, depending on the specified contributions the employer (and often the employee) has agreed to pay to a fund, the return achieved on the investment of contributions and the price of annuities at retirement. A defined contribution plan therefore fixes the input from the employer, with the output being variable.

3.3 The term defined benefit plan covers every plan that is not a defined contribution plan. In broad terms, the output is fixed by the plan and the input from the employer is variable. However, the present

³ This project does not address the accounting for pension contracts provided by insurers. These presently are included in the scope of IFRS 4 'Insurance Contracts', where life-contingent annuities and pensions are given as examples of insurance contracts.

⁴ IAS 19 defines 'post-employment benefit plans' as "formal or informal arrangements under which an entity provides post-employment benefits for one or more employees".

accounting requirements for defined benefits were developed mainly for the types of plan that guarantee a value for pension benefits on retirement that is based on salary and number of years worked. In those types of plan, the employer's obligation is variable and uncertain because the employer is exposed by the nature of its promise to risks such as the uncertain life expectancy of employees and, where a separate fund is in place, to the performance of its investments. The 'final salary' plan is an example of this type of plan.

3.4 More recently, there has been a trend away from the traditional defined benefit arrangements to (a) defined contribution arrangements (where employees rather than employers are exposed to the financial consequences of living longer and of the performance of investments) and (b) to new types of benefits that expose employers to less risk than the traditional type of benefit based on length of service and salary but to more risk than pure defined contribution arrangements. For example, some arrangements leave longevity risk with employees and some investment risk with employers by defining an amount of cash to be available at retirement rather than a specific amount of pension. Plans such as these which share some of the risks between employers and employees do not fit easily into the traditional defined contribution or defined benefit accounting models.⁵

3.5 Some believe the new types of benefits may become more prevalent in the future. For example, in the UK, a report to the Department of Work and Pensions entitled 'Deregulatory Review of Private Pensions' (published in July 2007) states that although many employers have in recent years turned to pure defined contribution schemes, many in the pensions industry believe this will not be the path of the future, noting that some employers will look for ways to bear some risk themselves on behalf of their employees, be it investment risk, longevity risk, or inflation risk in the retirement provision they offer.⁶

3.6 The present accounting standards read as if defined contribution plans and defined benefit plans are different types of animal. The reality appears to be that they are not and that there is considerable movement into the middle ground between the traditional defined contribution and defined benefit plans where there is more sharing of risks between employers and employees. For example, many plans are more like defined contribution plans but have some kind of agreement or guarantee from the employer about the rate of return on contributions.

3.7 This paper does not therefore take an approach that assumes there will be separate accounting requirements for defined contributions, defined benefits or any other categories of benefits. A drawback of that approach is that standards need to be revisited when new types of benefits are designed that do not appear to fit the accounting models for the categories that have been defined. If different types of

⁵ In the first phase of IASB's project to improve pensions accounting, the IASB is considering adding a further category of plan – a defined return benefit plan – where the employer's obligation is not confined to making specified contributions but includes a guaranteed level of return on specified contributions.

⁶ 'Deregulatory Review of Private Pensions – An independent report to the Department for Work and Pensions' (July 2007), Chris Lewin and Ed Sweeney.

obligations can be encompassed in a single framework of principles, there would be consistent accounting treatment of similar arrangements in the spectrum of pension benefits and the accounting treatment of different arrangements would reflect the economic differences between them.

3.8 This paper therefore takes that approach, by exploring the fundamentals that might be applicable to any type of benefit, starting (in Chapter 2) by considering how to define the employer's liability in any pension plan, and going on to consider principles for recognising and measuring assets and liabilities that arise from pension plans, reporting gains and losses and disclosing information about pension plans in financial statements. It follows that if the accounting for pure defined contribution plans would stay the same as it is now, it would not be because a definition is satisfied but because the accounting principles would lead us to the conclusion that, in their case, the current accounting is appropriate.

4 Summary

4.1 This paper sets out views on how pension arrangements including the obligation to provide pensions (including lump sums payable at or near retirement) are best reflected in financial statements. It considers both the financial statements of the employer and those of a pension plan.

4.2 Although the underlying principles might be expected to be similar for all long-term benefits, this paper focuses on pensions.

4.3 One of the perceived difficulties with existing pension standards is that they draw a sharp distinction between defined contribution and defined benefit plans. This is particularly troublesome when, as is increasingly the case, pension plans have elements of both types. The paper takes the approach of considering the fundamental principles, which should be common to all pension plans.

Chapter 2: Liabilities to pay benefits

1 Introduction

1.1 From the perspective of an employee, a right to receive a pension is a form of deferred remuneration that usually accrues as he or she renders service in exchange for promised benefits.

1.2 Conversely, an employer that provides pension benefits as part of its remuneration usually incurs an obligation when employees render service in exchange for benefits promised under the plan. That is true even if no cash is spent until the employee retires.

1.3 An employee's rights must be someone's obligation. Sometimes that obligation, or part of it, is taken on by parties other than the employer. An example is when an employer's obligation is to contribute to a personal pension contract with a life insurance company and that company assumes all obligation to pay benefits.

1.4 The financial reporting of pensions is concerned with how the exchange of pension benefits for services is reflected in financial statements, by recording a value for the services received (reported as an expense or part of the cost of an asset) and the liability incurred, and recording a value for the liability at each reporting date until it is extinguished.

1.5 The Framework deals with the recognition of liabilities as follows. An item should be recognised as a liability if:

- the item meets the definition of a liability; and
- it is probable that a transfer of economic benefits will be required; and
- the item can be measured reliably.

1.6 This Chapter addresses the first criterion, setting out views on which possible future pension benefits should be (or should not be) reflected in the reported liability to provide pension benefits. When considering the accounting in employers' financial statements, it is necessary as a first step to define the employer's liability in any pension arrangement. It would be premature to consider how a liability should be measured before understanding what the liability is. This might appear to be straightforward but, as shown in the discussion below, there are some difficult issues around defining exactly what the liability is in the case of pensions.

1.7 The approach in this paper is to consider first the totality of the liability for pension benefits that corresponds to the employee's right to receive benefits and then to consider how much of that liability is owed by the employer and how much is owed by other parties. Chapter 3 sets out views on how assets and liabilities might be defined in the financial statements of the employer and other entities (including

trusts or similar entities that are sponsored by the employer) when funds for the payment of benefits are transferred to other entities.

2 Definition of a liability

Existing international accounting standards and developments

2.1 The present definition of a liability in the Framework is:

“A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.”

2.2 An *obligation* is something an entity cannot avoid. A *present obligation* must have arisen from a past transaction or event.

2.3 IAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’ applies the definition of a liability to provisions generally, which are liabilities of uncertain timing or amount. IAS 37 requires that, in order to meet the definition, an obligation must be either a legal obligation or a constructive obligation. For a present obligation to exist, it is necessary that (a) the entity has no realistic alternative to settling the obligation and (b) the obligation exists independently of the entity’s future actions (i.e. the future conduct of its business).¹ IAS 37 is currently being amended to clarify which obligations are legal or constructive obligations that meet the definition of a liability. The amendments being considered, and the rationale for them, are highly relevant to the consideration of pensions obligations.

Legal obligations

2.4 A legal obligation is defined in IAS 37 as an obligation that derives from a contract (through its explicit or implicit terms), legislation or other operation of law.

Constructive obligations

2.5 The current exposure draft² of amendments to IAS 37 (July 2005) defines a *constructive obligation* as:

“A present obligation that arises from an entity’s past actions when:

¹ IAS 37, paragraphs 17 and 19.

² The exposure draft’s definition is included to provide the most up to date definition; however, it is not very different from the existing IAS 37 definition.

- (a) by an established pattern of past practice, published policies or a sufficiently current statement, the entity has indicated to other parties that it will accept particular responsibilities; and
- (b) as a result, the entity has created a valid expectation in those parties that they can reasonably rely on it to discharge those responsibilities.”

2.6 The exposure draft explains that an essential characteristic of a liability is that the entity has a present obligation to others that arises from a past event. For a past event to give rise to a present obligation, the entity must have little, if any, discretion to avoid settling it. Paragraph 15 provides the following guidance:

“In the absence of legal enforceability, particular care is required in determining whether an entity has a present obligation that it has little, if any, discretion to avoid settling. In the case of a constructive obligation, this will be the case only if:

- (a) the entity has indicated to other parties that it will accept particular responsibilities;
- (b) the other parties can reasonably expect the entity to perform those responsibilities; and
- (c) the other parties will either benefit from the entity’s performance or suffer harm from its non-performance.”

Stand-ready obligations

2.7 The exposure draft of amendments to IAS 37 proposes that contractual rights and obligations can be divided into two types: *conditional* (or contingent) and *unconditional* (or non-contingent). It proposes that liabilities only arise from *unconditional* obligations and that an obligation that is contingent or conditional on the occurrence or non-occurrence of a future event does not by itself give rise to a liability.

2.8 However, the exposure draft also proposes that many possible obligations that have previously been thought of as contingent liabilities do in fact contain unconditional obligations. The unconditional obligation is referred to as ‘stand ready obligation’ and is a liability. A ‘stand ready obligation’ will exist in situations when there is uncertainty about the amount of cash that will be required to settle a present obligation and can be described as an unconditional obligation to ‘stand ready’ to fulfil the contingent or conditional obligation *if* the uncertain future event occurs. An example is a guarantee of another entity’s borrowings, where a present obligation exists to ‘stand ready’ to repay the other entity’s borrowings. The contingency that makes the outcome uncertain (which in this example includes the likelihood that the other entity will default on its borrowings) will then be reflected in the measurement of the liability by assigning probabilities to possible outcomes.

Further developments

2.9 The IASB plans to issue a final revised version of IAS 37 in 2008. The IASB has not yet concluded its discussions about the proposed amendments in relation to constructive obligations and stand ready obligations, which are contentious. The project reports³ note that the IASB has tentatively concluded that a present obligation exists when (a) an entity is irrevocably committed to act in a particular way; and (b) an external party has an enforceable right to call upon the entity to act in that particular way.

Framework project

2.10 For the longer term, the IASB and FASB are reconsidering the definition of a liability in their respective conceptual frameworks. The working definition in the project reports would draw the boundary of a liability to represent obligations that are legally enforceable or enforceable by equivalent means.

2.11 The direction of the changes being considered to the definitions of constructive obligations and liabilities seems to be to raise the threshold for determining whether an entity's past actions have created a constructive obligation that meets the definition of a liability. This has significant implications for a future accounting standard on pensions – if inconsistencies with the accounting treatment of other liabilities are to be avoided – when considering which benefits are liabilities and which benefits are not.

Applying the principles to pensions

2.12 In relation to liabilities generally, adhering to the Framework means that:

- (i) only present obligations of an entity (i.e. obligations that exist today, rather than possible obligations) give rise to liabilities, and
- (ii) present obligations should be recognised as liabilities if they can be measured reliably.

2.13 This paper considers those fundamentals (recognition is considered in Chapter 4). In the context of the definition of a liability, the promise of pension benefits may give rise to the following sources of present obligations:

legal obligations (on the basis of a contract setting out the rights and obligations of the employing entity and past and present employees), or

constructive obligations (if the accounting treatment of pension liabilities is to be consistent with other liabilities, the scope of constructive obligations ought to be consistent with the IASB's conclusions on its revisions to IAS 37).

³ IASB Update March 2007 and May 2007.

2.14 The range of pension benefit designs is diverse. Furthermore, the amount of pension benefits that employers ultimately have to pay is usually uncertain. A wide range of factors may contribute to this uncertainty, as indicated below.

2.15 In some cases it seems clear that particular sources of uncertainty in an arrangement concern the *measurement* of a present obligation, not whether a present obligation *exists*. In such cases, it can be concluded that the entity is presently committed to provide specified benefits but the amount is uncertain. Examples are:

- longevity of employees and their dependants (when there is a present obligation to pay employees pensions from when they retire until they die, and so the amount of benefits depends on how long employees live after retirement),
- future inflation (when the benefits are linked to variables such as future inflation in prices, wages, or the level of state pensions),
- the price of annuities at retirement (when an entity has guaranteed a rate of annuity to employees when they retire),
- employees' length of service (if expected future salary levels or unvested benefits are required to be taken into account),
- options available to plan members for receiving benefits (when members have flexibility to take benefits as cash lump sums or pensions),
- the likelihood and financial consequences of death or ill health during employment (when specific benefits are payable in the event of death or ill-health),
- the return achieved on the investment of contributions (when the amount of benefits depends on the return on investments),
- the continuing solvency of the employer and/or other pension providers.

2.16 With some other sources of uncertainty, it is less clear whether (or why) the uncertainty should be taken into account in measuring the present obligation that exists at the reporting date. In the language of the Framework, there is a debate about whether the uncertainty concerns the *recognition* or *measurement* of a liability. If an obligation (or a change in an obligation) that is conditional on whether a future event occurs or does not occur is not recognised unless and until the future event occurs, it will not be included in the measurement of present obligations. Instead, a liability (and expense) will be recognised in the period when the future event occurs. Examples of such sources of uncertainty are:

- whether vesting conditions will be satisfied,
- the level of future pensionable salaries (when benefits are related to employees' salaries),

- benefits that the employer has discretion to vary,
- future changes to terms and conditions of a plan, when these are not present options of the employer.

2.17 **The principles underlying the definition of a liability should provide a basis for determining:**

- (a) **which uncertain future events are reflected in present obligations that exist today (when the probabilities of different outcomes are reflected in the measurement of the liabilities and of expenses that are recognised as services are provided), and**
- (b) **which uncertain future events are not taken into account until they occur (when they give rise to different liabilities than have been previously reported and expenses that are not recognised until the events occur).**

2.18 The rest of this Chapter addresses the above statement by considering the following questions:

- (a) **when does a liability begin to arise? (Section 3)**
 - (i) when the promise of a benefit is made?
 - (ii) when services are provided?
 - (iii) when benefits vest?
- (b) **should the liability reflect benefits that the entity might become committed to in the future? (Section 4)**
 - (i) when an employer has discretion to vary pension benefits, should the effect of discretionary behaviour be estimated and reflected in the measurement of liabilities and of expenses that are recognised as services are provided?
 - (ii) when benefits are linked to salaries, should the effect of future salary increases be reflected in the measurement of liabilities and of expenses that are recognised as services are provided?
 - (iii) should possible modifications to terms and conditions be reflected in the measurement of liabilities and of expenses that are recognised as services are provided?
- (c) **what is the unit of account for a liability to pay pensions? (Section 5)**
- (d) **how should benefits be attributed to periods of service to arrive at a measure of expense and additional liability relating to services rendered in each financial reporting period? (Section 6)**

3 When does a liability begin to arise?

3.1 It has been generally accepted for many years that a liability to pay benefits usually arises before an employee becomes entitled to receive them on retirement or when benefit payments fall due. To argue otherwise would portray a benefit as something that is given gratuitously rather than something that the employee has earned a right to receive in consideration for services given to the employer. Accordingly, this possibility is not considered further in this paper.

3.2 Some take the view that a liability arises as soon as the promise of a benefit is made. Others take the view that a liability does not arise before services are provided. If the latter view prevails, a further fundamental issue is whether a liability can arise before benefits vest unconditionally in employees, i.e. when employees do not become entitled to benefits until a specified period of service is completed. These three possibilities are considered below.

When the promise of a benefit is made?

3.3 One view is that there is only one past event that gives rise to a present obligation, namely the giving of the promise of a pension benefit for services provided. This might be, for example, at the start of employment or admission to the plan.

3.4 Under this view, determining the amount of the liability is entirely a measurement issue. Measurement would reflect all the options and uncertainties that might affect the outcome. To determine whether a liability exists, it is unnecessary, for example, to distinguish benefits relating to past service from benefits relating to future service because the value of the obligation increases as services are provided.

3.5 Under this view, the obligation to pay benefits for future service is akin to an option granted within the pension contract. Some might consider that the right conveyed to employees to accrue future benefits through continued membership of a pension plan has a value that could be recognised in financial statements.

When services are provided?

3.6 A different view is that, although the initial contract to provide benefits is important for considering the pattern in which obligations emerge, there may be a number of events that give rise to present obligations within the overall pension promise. Some of these come into existence later than the time at which the promise is given.

3.7 At the first level, benefits can be distinguished between benefits relating to *past service* and benefits relating to *future service*. Under this view, pension obligations arise when pension benefits are provided in exchange for services; in other words, the provision of service is the past event that gives rise to the right to receive, and the obligation to pay, a pension.

3.8 Obligations to provide benefits relating to future service are, under this view, not present obligations; instead they may be viewed as obligations to exchange. Under present accounting conventions, obligations such as these (which are often referred to as executory contracts) are not usually recognised in financial statements until the underlying exchange takes place (unless the contract is onerous).

3.9 The principle in IAS 19 *Employee Benefits* is that a present obligation is created when an employee renders service in exchange for benefits promised under the plan. IFRS 2 *Share-based Payment* is similar in that, for cash-settled share-based payments that give rise to liabilities, it requires an entity to recognise an expense for services received and a liability to pay for those services as employees render service. This principle is not believed to be contentious.

3.10 The 'promise date' and 'service date' views on when a liability arises may be contrasted thus. Under the 'promise date' view, all possible cash outflows arising from the benefit promise should be reflected in the measurement of the liability. Under the 'service date' view, there is valid discussion to be had about when present obligations for various other elements of the promise come into existence, including benefits that have not yet vested and possible benefits that the employer is not yet committed to provide.

3.11 The 'promise date' view is not advocated in this paper. It is considered that there is no good reason to treat the promise of a pension differently from other executory contracts which are usually recognised as liabilities when the underlying exchange takes place. It is concluded that for financial reporting purposes, the rendering of services is the obligating event that gives rise to a present obligation and moving away from this view would not lead to the provision of more useful financial information.

3.12 This paper concludes that pension obligations arise under employment contracts in which pension benefits are provided in exchange for services. It is at the time at which services are provided that a liability arises.

When benefits vest?

3.13 The principle that a liability arises when services are provided might appear to be straightforward, but it is not. Service gives rise to the recognition of a liability and an expense, but allocating benefits between past and future service can be difficult. The first question is whether a liability can arise before benefits vest unconditionally with the employees. The discussion below considers examples of vested and unvested benefits.

Vested benefits

3.14 Vested benefits are benefits for which the employee's right to receive benefits in relation to past service is not conditional on remaining in the service of the employer.

Example 1

The benefit is a lump sum, payable on retirement, equal to 100 for each year of service. The benefits vest immediately.

Example 2

The benefit is a lump sum, payable on retirement, equal to 10% of the employee's salary earned in each year of service. The benefits vest immediately.

Example 3

The benefit is an annual pension, payable from retirement until death, equal to 2% of the employee's salary earned in each year of service. The benefits vest immediately.

3.15 It seems clear that vested pension benefits give rise to present obligations. The present obligation is an unconditional obligation to provide benefits to the employee (or dependants) in relation to past service. In Example 1, for each year of service a present obligation arises to pay 100 at a future date. In Example 2, for each year of service a present obligation arises to pay 10% of the employee's current salary at a future date. In Example 3, for each year of service a present obligation arises to pay a pension equal to 2% of the employee's current salary. (The question of determining how benefits earned by employees accumulate as they render service is considered further in Section 5.)

3.16 Factors that may contribute to uncertainty as to the amount that will ultimately be paid in respect of vested benefits (for example, the longevity of employees in Example 3) will be taken into account in measuring the present obligation that exists at each reporting date.

Unvested benefits

3.17 Unvested benefits are benefits for which the employee's right to receive benefits is conditional on completing a specified period of future service, i.e. the employee receives no benefits if he leaves before the end of the specified period. Such conditions are sometimes included to retain and motivate staff.

Example 4

The benefit is a lump sum, payable on retirement, equal to 100 for each year of service. The benefits vest after ten years of service (i.e. the employee receives no benefits if he leaves before ten years). After ten years the employee is entitled to 1,000 (10 × 100) on retirement.

3.18 IAS 19 reflects the former International Accounting Standards Committee's (IASC) conclusion that an unvested benefit meets the definition of a liability in the Framework:

"The Board believes that an enterprise has an obligation under a defined benefit plan when an employee has rendered service in return for the benefits promised under the plan.....The Board believes that an obligation

exists even if a benefit is not vested, in other words if the employee's right to receive the benefit is conditional upon future employment. For example, consider an enterprise that provides a benefit of 100 to employees who remain in service for two years. At the end of the first year, the employee and the enterprise are not in the same position as at the beginning of the first year, because the employee will only need to work for one year, instead of two, before becoming entitled to the benefit. Although there is a possibility that the benefit may not vest, that difference is an obligation and, in the Board's view, should result in the recognition of a liability at the end of the first year. The measurement of that obligation at its present value reflects the enterprise's best estimate of the probability that the benefit may not vest." (IAS 19, Basis for Conclusions, paragraphs 13-14)

3.19 Some may take the view that there is no liability (or expense) until the benefits vest. Under this view the entity does not have a present obligation as it does in Examples 1-3, because an employee might leave or be dismissed before the benefits vest. Some would point out, in support of this view, that increases in other elements of remuneration, such as salaries, are not usually recognised as liabilities and expenses before they vest.

3.20 The contrary view, which is consistent with the present requirement in IAS 19, is that the employer is committed to pay benefits for service during the vesting period, but the amount is uncertain. Under this view, the employee is providing services during the vesting period and part of the employee's reward for those services is the conditional right to receive a retirement benefit – the conveyance of this right creates an obligation on the employer that it cannot avoid. Example 4 illustrates a situation where employees are clearly earning something of value for each year of service and so a liability accumulates over ten years' service for those who achieve ten years' service.

3.21 Stated differently, a view of Example 4 is that, if the employee has the option to continue in employment and collect the retirement benefit, the employer has entered into a transaction that has characteristics of having written an option to the employee. This gives rise to a present obligation to the employee that is akin to a 'stand ready obligation' as described in paragraph 2.8 above, i.e. an obligation to 'stand ready' to make a payment to the employee in respect of past service *if* the employee completes the specified period of service. The probability that employees will forfeit their rights by leaving before the end of the vesting period would be reflected in the measurement of the liability.

3.22 It is implicit in this view that the employer has an obligation to remunerate the employee in exchange for services provided that it cannot avoid. In the language of the present IAS 37, the employer has no realistic alternative to settling the obligation, because there is an obligation either (a) that can be enforced by law or (b) that the employer has given the employee a valid expectation of discharging. (In the language of the exposure draft of amendments to IAS 37, the employer has 'little, if any, discretion' to avoid settling it.) Underlying this view is the belief that in most cases the operation of social and labour law, and even the employer's past practice of not dismissing employees shortly before the vesting date, would mean that the employer would not realistically be able to dismiss its employees before benefits were due to vest without compensation. However, if that were the case, a different view would be taken on whether a liability exists. Some argue that this is particularly relevant if the employer's obligation to

its workforce is viewed on a portfolio basis, because the employer would not realistically be able to shed the whole workforce (see discussion of the unit of account in Section 5).

3.23 In the light of the above discussion, it is concluded that the liability that arises when service is provided includes, in addition to vested benefits, benefits in respect of services provided before vesting, because an employer cannot realistically avoid his promise (or can cancel it only on payment of compensation).

Right to join a plan after a period of service

3.24 Some plans have service entry criteria. In such plans, at an employee's commencement of employment the employee is given the right to join the plan on attaining a certain age or after a qualifying period of service.

Example 5

The benefit is a lump sum, payable on retirement, equal to 100 for each year of service, excluding service before the age of 25. The benefits vest immediately.

Example 6

Benefits commence after five years' service. Thereafter, the benefit is a lump sum, payable on retirement, equal to 100 for each year of service, excluding service during the qualifying period.

3.25 Under IAS 19 (paragraph 67) no liability or expense is recognised until "the date when service by the employee first leads to benefits under the plan (whether or not the benefits are conditional on further service)." Therefore, in Example 5, no liability is recognised in respect of service before the age of 25 and, in Example 6, no liability is recognised before the end of the qualifying period of five years' service.

3.26 Those who would take the view that there is no liability (or expense) for unvested benefits until the benefits vest would also agree that no liability should be recognised in Examples 5 and 6 before the employee becomes eligible to receive benefits.

3.27 Some who believe that a present obligation can arise before benefits vest take the view that the employer's commitment gives rise to a present obligation from the commencement of employment. Under that view, the present obligation would be akin to a 'stand ready obligation' to commence the benefits as and when the employee reached the age of 25 or achieved five years' service. They argue that it would be inconsistent with the conclusion on Example 4 if benefits that vest after a long period of service are not attributed any value until they vest. In other words, the promise of future participation in the plan conveys present rights to employees and present obligations to the employer that have some value.

3.28 Others take the view that, if employees do not receive any 'backlog' of benefits for past service (vested or unvested) when they become eligible to join the plan, they are not earning anything of value for services before then. In other words, the benefits are not benefits in respect of services provided before vesting. In accordance with the view in paragraph 3.11 that the rendering of services is the obligating event, the employer's commitment may be viewed as an obligation to pay benefits relating to *future* service which, under this view, is not a present obligation. Thus for each year of service after age 25 or five years' service respectively, a present obligation to pay a benefit of 100 arises from an employee's service in that year. It is therefore claimed that the substance of both of these arrangements is similar to that of arrangements in which other elements of remuneration are increased as employees progress through their careers.

3.29 The conclusion may be drawn that if employees become eligible for benefits after a qualifying period of service, no liability would arise in respect of services provided during the qualifying period unless the benefits are in respect of services during that period and the employer has an obligation that it cannot realistically avoid.

3.30 The subject of attributing benefits to periods of service is considered further in the Section 6, including situations when service in later periods leads to higher benefits than service in earlier periods.

4 Should the liability reflect benefits that the entity might become committed to in the future?

4.1 This section starts by affirming that when an entity is committed to increasing pension benefits, albeit by an unknown amount, a liability in respect of future increases arises when services are provided.

4.2 It then goes on to consider whether, in addition, there is a liability for benefits that the entity might become committed to in the future. In particular, it sets out views on three related topics:

- (i) when an employer has discretion to vary pension benefits, should the effect of discretionary behaviour be reflected in the liabilities and expenses that are recognised as services are provided?
- (ii) when benefits are linked to salaries, should the effect of future salary increases be reflected in liabilities and of expenses that are recognised as services are provided?
- (iii) should possible modifications to terms and conditions be reflected in liabilities and of expenses that are recognised as services are provided?

If any of these were considered to be part of the liability then their amount and probability of occurrence would be estimated and reflected in the measurement of the liability.

4.3 Two views may be contrasted thus:

- (i) under the view that the liability reflects only benefits that the entity is committed to now, a charge (or credit) to profit or loss is recognised when the value of accrued pension benefits is increased (or decreased) by subsequent actions,
- (ii) under the view that the liability reflects also benefits that the entity might become committed to in the future, an estimate of the increase (or decrease) in the value of accrued pension benefits will already have been recognised by the time it occurs.

Employer has little or no discretion to avoid increasing pension benefits

Increases guaranteed by law or contract

4.4 In many jurisdictions, future increases in pensions in payment, pensions in deferment or benefits earned by employees in service are guaranteed by law or contract in order to provide some protection against inflation. The amount of increases is sometimes linked to price inflation, sometimes to salary inflation. Sometimes indexation is limited to a maximum amount.

Example 7

The benefit is a lump sum, payable on retirement, equal to 10% of the employee's salary in each year of service. The benefit is, however, increased in line with changes in the consumer price index from the period it is earned until it is paid. The benefits vest immediately.

4.5 The benefit in Example 7 is the same as in Example 2, except that in Example 7 the amount promised on retirement is increased to reflect price inflation. The promised benefit in Example 7 for each year of service is clearly more valuable than in Example 2. It is clear that the entity is committed to inflation-related increases, although it does not know how much they will be.

Example 8

The benefit is a lump sum, payable on retirement, equal to 10% of the employee's salary in each year of service plus a guaranteed return of 5% per year on the contributions.

4.6 The benefit in Example 8 includes the guarantee of a specified return on contributions for each year of service. The guarantee gives rise to a present obligation, which means that the guarantee should be reflected in the liability that arises during service.

4.7 **It seems clear that the present obligation includes future increases to benefits that are guaranteed by law or contract, which means that expectations of future increases should be reflected in the liability that arises during service.**

Constructive obligations to increase benefits

4.8 In some plans, although benefit increases may not be guaranteed by law or contract, constructive obligations to past and/or present employees may be inferred from past actions, e.g. when there is an established practice of granting increases every year.

4.9 For this purpose, what would be deemed to be a constructive obligation ought to be consistent with the criteria that emerge from the IASB's revision to IAS 37 in order to achieve greater consistency in the accounting for such benefits. The present guidance on constructive obligations in IAS 19 is quite permissive. For example, paragraph 52 states: "An example of a constructive obligation is where a change in the entity's informal practices would cause unacceptable damage to its relationship with employees." An NAPF Policy Paper *Accounting for Pensions: Pensions accounting in financial statements prepared under International Financial Reporting Standards* (November 2004) notes that in practice constructive obligation has been widely interpreted and future pension increases are usually included even when they are discretionary.

4.10 Under the proposed definition of a constructive obligation in the current exposure draft of amendments to IAS 37, an entity would have to create a valid expectation (of increases) that the members should be reasonably able to rely on (see paragraphs 2.5-2.6, 2.9 above). Members may hope that increases will be given – perhaps because the employer has a policy of considering giving increases and has given them from time to time – but hope would not be sufficient to give rise to a constructive obligation.

4.11 If constructive obligations to give increases to benefits were accounted for differently from expected discretionary increases to benefits (see discussion in paragraph 4.13 et seq), in practice it would be necessary to consider all the circumstances because there would be a spectrum of expectations. This ranges from the hope that increases would be paid, through an expectation that they would be paid, to grounds for believing that increases would be paid and at some point along that spectrum the expectation would become sufficiently valid for a constructive obligation to exist.

4.12 It seems clear that the present obligation includes future increases to benefits if an entity has a constructive obligation to give them, which means that expectations of future increases should be reflected in the liability that arises during service. Constructive obligations ought to be as defined in IAS 37 or any revision.

When an employer has discretion to vary pension benefits, should the effect of discretionary behaviour be estimated and reflected in the measurement of liabilities and of expenses that are recognised as services are provided?

4.13 In some plans, there is considerable employer discretion to change benefits during the life of the plan.

4.14 Benefits referred to as 'discretionary' include future increases in pensions in payment, pensions in deferment or benefits earned by employees in service that are not legal or constructive obligations (as defined in the accounting standards on liabilities). For example, an entity may have a policy that it will consider making benefit increases over and above any increases guaranteed in the plan rules and has a past practice of granting increases from time to time.

Example 9

A plan's normal retirement age is 65. The employer has had a policy of allowing employees aged 60 and over to take early retirement and draw a pension immediately without reduction from the pension that they would be entitled to at age 65 under the terms of the plan. The employer is, however, entitled to refuse to pay enhanced benefits for early retirement and has been taken over by another entity whose management has decided that it will no longer approve enhanced benefits.

4.15 Two broad views emerge on this issue.

4.16 **Some believe that there is only one present obligation – a contractual obligation to pay a pension for past service. It is an obligation of an uncertain amount.** Under this view, if an employee is owed a pension for, say, ten years' service, the only issue is to estimate how much it will cost. **The present obligation is not limited to reflecting estimates of future payments that the entity is presently committed (by legal or constructive obligation) to pay. Therefore, all expected payments, including benefits that the entity might become committed to in the future, should be reflected in the liability.**

4.17 Under this view there is already a liability for an element of future increases that are discretionary. Therefore, estimates of future increases in benefits will already have been recognised by the time they occur. Thus in Example 9, the liability for past service (and the pension expense for each period) should reflect expectations of enhanced benefits. An argument is that the rights of employees who hope to receive more generous benefits and the obligations of employers who have a policy of considering giving them are more valuable than when discretionary increases are not in prospect, and so the economic cost to the employer of current service is greater.

4.18 **Others believe that the present obligation includes only benefits that the entity is presently committed (by legal or constructive obligation) to pay. Under this view, the practice of granting increases to benefits relating to past service would have to meet the definition of a constructive obligation in its own right in order to give rise to a present obligation. If it does not, a second event – say, the announcement of a discretionary increase – is necessary to confirm a present obligation in respect of the element of benefits that is discretionary.**

4.19 Under this view, a liability (and expense) does not arise in respect of future increases in benefits until the entity is committed (by legal or constructive obligation) to pay them. Thus in Example 9, the liability for past service (and the pension expense for each period) should be based on the benefits that the

employer is presently committed to provide and should not reflect expectations of enhanced benefits.

4.20 Those who interpret the liability definition in this way believe that this treatment would assist entities to report transparently what they are committed to at the reporting date. They believe that this provides the clearest view for users of the entity's obligations. As mentioned earlier, it is not possible to encapsulate all relevant information about the nature of pension obligations in the numbers that are reported in the balance sheet or income statement. Under this view, information about possible future commitments that might arise from management's future actions would be clearer to users if it were communicated by separate disclosure rather than by recognition as part of an already complex liability.

4.21 Some believe there is a significant difference in the economic burden of a plan in which the entity has discretion and a plan in which an entity is committed to provide benefit increases - for example, it is widely believed that introduction of mandatory indexation of benefits in the UK imposed a considerable additional economic burden on pension plans. They are concerned that an approach that reflects all expected payments in the measurement of existing liabilities means that the costs associated with decisions taken in future periods are disguised in financial statements because they have been anticipated in earlier periods. In their view this goes against the grain of the recent efforts of accounting standard setters to preclude the recognition of liabilities in respect of future costs when a legal or constructive obligation does not exist. They believe that this is a 'profit-smoothing' approach which is not representationally faithful of the activities of each period.

4.22 Some have advised that discretionary increases to benefits are often granted only if adequate funding is in place. They believe it would be wrong to reflect as a liability possible increases to benefits that would not be considered unless justified by future investment returns, which are not reflected as assets. In such circumstances, they believe the financial consequences of changes to benefits should be recognised when the decisions are made.

4.23 Some have noted that past practice and expectations of discretionary benefits are likely to change in response to changing circumstances. They believe that even if inclusion of discretionary benefits could be justified conceptually, they could not be measured reliably.

4.24 This paper concludes that only benefits that the entity is presently committed (by legal or constructive obligation) to pay should be reflected in the liability.

Contingent benefits

4.25 Somewhere between guaranteed benefits and discretionary benefits is a range of benefits that might be described as contingent, i.e. benefits that will crystallise if a specified contingency occurs. Examples are plans that are required to pay pensions that increase with inflation, but increases are subject to the financial position of the sponsoring employer or (in a funded plan) the funding position of the plan. Such contingent benefits differ from discretionary benefits in that there is a conditional obligation under law or contract to give benefits.

4.26 As discussed in paragraph 4.16 above, some view the accounting for such benefits as a *measurement* issue. Consider, for example, the situation where an employer has an obligation to increase pensions in line with inflation, but has an option to reduce or even eliminate an increase if the financial position of the plan becomes poor. Under this view, the liability would be reported at a lower amount to reflect the probability that the plan's financial position will become poor and that pensions will be increased by a lower amount than they would otherwise be.

4.27 Others believe that, as with their view of discretionary benefits in paragraph 4.18 above, contingencies may concern the *recognition* of liabilities. We say 'may' because clearly contingent arrangements can be complex and it is not possible to make general assertions as to whether contingencies concern recognition or measurement. However, it is reasoned that some future events give rise to new obligations or change the obligations that presently exist, in which case the effects are not recognised until they occur.

4.28 One example is when increases in benefits depend on the performance of investments. Under this view, changes in the value of investments and consequent changes in the liability to pay benefits should both be recognised when they occur. For example, if an employer has an obligation to use a surplus in a plan to increase benefits, a liability to increase benefits would arise when the surplus arises.

4.29 Another example is when increases in benefits are subject to an entity's financial position. Consider the benefit in Example 7 (paragraph 4.4). It was concluded that the contractual promise to give index-linked increases is a liability. In the language of IAS 37, the obligation exists independently of the entity's future actions. Under this view, there is a similar argument in relation to a benefit that is contingent on an entity's financial position – the obligation cannot realistically be avoided because the entity would have to damage itself economically in order to avoid it. Consequently, the liability to increase benefits is not reduced to reflect possible future changes in the entity's financial position

4.30 **This paper puts forward the view that reported liabilities should not reflect the effects of possible future changes to an entity's financial position or a plan's funding position – if such events occur with consequences for the amount of benefits that are given, all of the effects should be recognised when they occur.**

When benefits are linked to future salaries, should the effect of future salary increases be reflected in the measurement of liabilities and of expenses that are recognised as services are provided

4.31 Many benefit designs link the amount of benefits to the employee's salary at or near retirement or leaving service. One of the most difficult questions is whether the liability that arises during service should reflect the effects of future salary increases.

4.32 There seem to be two pervasive issues:

- (i) Membership of a final salary pension plan is usually considered to be a more valuable benefit than membership of a current or average salary plan, because it is usually assumed that salaries will increase during an employee's career. If it is more valuable, when should the difference be reflected in the financial statements?
- (ii) Does the entity have an obligation (legal or constructive) to increase benefits that have been earned by increasing pensionable salaries?

4.33 The following example is based on the example accompanying paragraph 65 of IAS 19, which illustrates the required 'projected unit credit' method to determine the present value of defined benefit obligations and current service cost.⁴ This is a simple example of a final salary plan.

Example 10

A lump sum benefit is payable on termination of service and equal to 10% of final salary for each year of service. The salary in year 1 is 10,000 and is assumed to increase at 7% (compound) each year.

The benefit attributed to each year (using the projected unit credit method) for an employee who is expected to leave at the end of year 5 is set out in Column B of Table 1 below. Under this method, a benefit equal to 10% of *expected final salary* is attributed to each year of service.

Table 1 also sets out, in Column A, the benefit that would be attributed to each year if the service cost was based on *current salary* rather than expected final salary. Under this method the liability at each reporting date is equal to 10% of current salary for each year of service – for example, in year 2 the liability of 2,140 is 10% of 10,700 (1,070) × 2 years service. The expense for each reporting period is equal to the increase in the liability.

⁴ An objective of the 'projected unit credit' method is to provide a stable contribution rate for active members, as a percentage of pensionable salary, if there is a stable membership of a plan, i.e. if leavers are balanced by new entrants. In calculating the actuarial liability, pensionable salary is projected up to the assumed end of an employee's career.

For simplicity, discounting is ignored in this illustration (alternatively, it could be said that a discount rate of 0% is assumed).

Table 1

Final salary plan

Year	Expected salary	Benefit attributed			
		A		B	
		Current salary		Final salary (10%) (IAS 19)	
		Current period	Liability accumulated	Current period	Liability accumulated
1	10,000	1,000	1,000	1,311	1,311
2	10,700	1,140	2,140	1,311	2,622
3	11,449	1,295	3,435	1,311	3,933
4	12,250	1,465	4,900	1,311	5,244
5	13,107	1,655	6,555	1,311	6,555
		6,555		6,555	

4.34 Standard-setters have previously taken the view that future increases in pensionable salaries should be reflected in the liability. Thus in Example 10 the liability at each reporting date during service reflects assumptions as to the employee's salary when he leaves service.⁵ For example, after one year's service the liability (and expense for the period) would reflect 10% of the employee's estimated *final* salary (Column B in Table 1).

4.35 Some have argued that future salary increases should not be reflected in the liability. Thus in Example 10 the liability at each reporting date would reflect only the benefit earned by the employee if he left service at the reporting date (Column A in Table 1).⁶

⁵ This measure of liability is referred to in SFAS 87 as the 'Projected benefit obligation' (PBO).

⁶ This measure of liability is referred to in SFAS 87 as the 'Accumulated benefit obligation' (ABO).

4.36 As the above example illustrates, the effect of excluding expected future salary growth is that:

- (a) smaller liabilities are reported until the end of employees' service lives, and
- (b) a rising, rather than level, cost trend is reported during employees' service lives, because each increase in accrued benefits that results from an increase in pensionable salary is treated as an expense of the current period.⁷

The financial effect of including or not including future salary growth will vary according to the maturity of the plan (i.e. the effect is more pronounced the more active employees there are in the plan).

4.37 **Alternative views have coalesced around two positions:**

- (a) **Some believe that the liability for past service (and the pension expense for each period) should be based on expectations of employees' pensionable salaries when they leave service.**
- (b) **Others (including a majority of the ASB's members) believe that the liability for past service (and the pension expense for each period) should be based on the benefits that the employer is presently committed to provide – this would usually be benefits based on current salaries plus any increases that are required by law or contract and would include other increases that are seen as non-discretionary, i.e. in respect of which there is a constructive obligation. Under this view, the pension expense of each period will reflect the extra pension liability incurred by giving increases in pensionable salaries.**

Unit of account

4.38 An issue that will need to be drawn into the debate on a future accounting standard is the unit of account. Views on the unit of account are set out in Section 5 of this Chapter.

4.39 As noted there, some believe there is a different answer to the question whether the liability should reflect future salary increases if the issue is approached by focusing on the employer's obligation to the workforce as a whole rather than to an individual employee. In their view, even if it could be concluded that the employer does not have an obligation to increase pensionable salaries of any individual employee, that argument is much less plausible if the focus is on the workforce as a whole.

4.40 Others do not agree that taking the whole workforce, rather than the individual, as the unit of account should give rise to a different answer because they believe that, unless the employer has a constructive obligation to increase pensionable salaries of individuals, it cannot have a constructive obligation to the whole workforce..

⁷ In Column A of Table 1, for each year in which pensionable salary is increased by 7%, the pension expense increases by 13-14% compared with the previous year. The figures shown are, of course, before the effect of discounting.

View that expected future salary increases should be reflected

4.41 Present accounting standards set out their basis for the view that future salary increases should be reflected in the measurement of the liability:

IAS 19 (Basis for Conclusions, paragraph 36) states:

“The Board believes that the assumptions are used not to determine whether an obligation exists, but to measure an existing obligation on a basis which provides the most relevant measure of the estimated outflow of resources. If no increase is assumed, this is an implicit assumption that no change will occur and it would be misleading to assume no change if an entity expects a change.”

FRS 17 (Appendix IV, paragraph 12):

“The FRS requires the defined benefit liability to be the best estimate of the present value of the amount that will actually be paid out. For this to be the case, all expected changes in factors affecting the payments should be taken into account. For final salary liabilities, the liability will therefore be based on the expected final salary, not the current salary. Some argue that this is not consistent with FRS 12 because the employer has some control over the future increases in salary and hence does not have a present obligation relating to those increases. However, there is a difference between a present commitment to pay a pension based on present salary and a present commitment to pay a pension based on final salary, which the Board believes should be reflected in the measurement of the liabilities.”

SFAS 87 (Basis for Conclusions, paragraph 143) states:

“...the Board concluded that estimated future compensation levels should be considered in measuring the service cost component and the projected benefit obligation if the plan’s benefit formula incorporates them. The Board perceives a difference between an employer’s promise to pay a benefit of 1 percent of an employee’s final pay and a promise to pay an employee a fixed amount that happens to equal 1 percent of the employee’s current pay. Ignoring the future variable (final pay) on which the obligation in the first case is based would result in not recognising that difference.”

4.42 The thrust of the argument for including the effect of expected future salary increases is that the contractual arrangement as it exists today gives an unconditional promise to the employee that service given over the employee’s career will be priced at the rate of the employee’s final salary. Put simply, if employee A is in a final salary scheme and employee B is in a current salary scheme, the value of the promise to A is different from the value of the promise to B (all things being equal, the value of the promise to A is likely to be greater) and they should not, therefore, be reported at the same liability amounts.

4.43 Under this view the obligation to re-price the benefits is part of the present obligation relating to past service. Therefore, the present obligation at any point in time could be analysed as follows:

- part of the pension promise has vested (i.e. the benefit that relates to past service and current salary)
- part of the pension promise has not yet vested (i.e. the re-pricing from current salary to final salary is conditional on completing further service).

4.44 Some would consider the above analysis to be consistent with the suggested analysis of vested and unvested benefits in paragraphs 3.14-3.23 above. In particular, it was suggested that unvested benefits in relation to past service give rise to a present obligation to 'stand-ready' to make payments if the employee completes the specified period of service.

4.45 Some support this view by questioning whether the employer has the ability each year to adjust the total remuneration package (including the increase in value of accrued pension benefits) to a cash equivalent amount that reflects a fair value for the services each year. In their view, if the employer does not have the ability to do this, the reported expense in periods when pensionable salaries are increased is too large and the present obligation is undervalued.

4.46 It has been noted that some have argued that future increases in pensionable salaries should not be reflected in the liability because they are within the entity's control and are therefore (at least to some extent) discretionary. However, those who believe that expected future salary increases should be reflected consider that the obligation to pay a pension based on final salary is not discretionary – the question of discretion, if it arises, concerns the measurement of the obligation.

4.47 To sum up, supporters of this position respond to the two issues raised in paragraph 4.32 as follows:

- (i) The expectation of more valuable benefits in a final salary plan should be reflected in the measurement of liabilities and expenses reported during employees' service lives.
- (ii) It does not matter whether an entity has a legal or constructive obligation to increase pensionable salaries or whether it has discretion, because measurement of the liability to pay benefits should in both cases reflect the commitment to pay benefits related to final, not current, salaries.

View that expected future salary increases should not be reflected unless there is a commitment to increase pensionable salaries

4.48 Others disagree with the requirement in the present standards to anticipate expected future salary increases. They believe that only benefits that the entity is presently committed (by legal or constructive obligation) to pay should be reported as liabilities, not benefits to which the entity might become committed in the future. In their view, that principle should apply also to increases in pension benefits

that result from salary increases because they believe it provides the clearest view to users of an entity's obligations. They believe that in many situations there is no commitment to such increases, as argued below.

4.49 Employees typically become more expensive as they progress through their careers. In addition to paying higher current benefits as they progress, in a final salary plan the employer also makes the original pension promise more valuable with each increase in pensionable salary. Some believe that the current approach is inconsistent with the treatment of expected increases in other elements of remuneration – such as salaries and bonuses – which are accounted for in the periods in which they occur. They believe that the increase in value of an employee's pension benefits is in economic terms not distinguishable from the rest of the remuneration for each year of service – in effect it is a bonus in the form of additional pension benefits. Under this view the cost of promoting an employee includes an increase in the value of the employee's pension benefits (that is usually larger the longer the employee's service). That cost should be reflected as an expense of the period in which the decision to promote the employee is made, together with increases in other components of the employee's remuneration.

4.50 In response to the argument in 4.42 that the value of the promise to employee A (in a final salary plan) is likely to be greater than the value of the promise to employee B (in a current salary plan), some believe that the employer often has considerable discretion over the components of a competitive remuneration package. They point to many examples where managements have taken actions to change reward structures for future service to address the pension cost element, such as replacing pensionable salary increases with non-pensionable bonuses, replacing final salary benefits with career-average benefits, or even closing final salary plans to future accruals. They contend that it would be rational to expect employee A's pensionable salary to grow more slowly than employee B's pensionable salary to reflect the greater cost associated with each increase in employee A's pensionable salary. Put simply, under this view more of employee A's remuneration for each year is deferred. Reflecting the effect of pensionable salary increases when they occur therefore enhances rather than impairs comparability.

4.51 Under this view, if the total remuneration package (including the increase in value of accrued pension benefits) appears to give rise to an expense that purports to reflect the remuneration for the year that is above a fair value for the services, it nevertheless represents the true economic cost of employment and should be transparently reported as such each year.

4.52 Some who disagree with including future salary increases have similar concerns to those who believe that discretion matters when considering what benefits should be reflected in liabilities. They believe that this is also a 'profit-smoothing' approach (as illustrated in Table 1) which disguises the true economic cost of the activities of each period (including the consequences of expensive management decisions). They also believe that making the accounting more transparent should encourage rational decision making.

4.53 To sum up, supporters of this position respond to the two issues raised in paragraph 4.32 as follows:

- (i) The more expensive final salary plan is properly reflected in the financial statements by recognising as an expense of each period the salary for that period plus the extra pension liability incurred by giving that salary.
- (ii) An entity does not have an obligation to increase benefits that have been earned unless it has an obligation (legal or constructive) to increase future pensionable salaries.

View that some salary inflation should be reflected

4.54 Some believe that an inflation element of salary increases should be taken into account and perhaps also increases that usually arise from increasing age or length of service. They believe that such increases would fall into the category of benefits that the employer has little or no discretion to avoid.

4.55 They would contrast those increases with increases over which the employer is considered to have discretion, such as those related to promotion, merit or productivity. The effect of the latter would be considered to be a cost relating to service of the current period because it represents higher remuneration for the provision of a more valuable service than previously.

4.56 Others believe, however, that it is not possible to distinguish discretionary and non-discretionary elements of expected growth in future pensionable salaries. For example, they would question the validity of including some inflationary salary progression but excluding the effect of promotions, when the reality is that there is an expectation of both during an employee's career. They also believe that reflecting the effect of salary inflation in pension liabilities is not consistent with the treatment of future inflationary increases in other elements of employees' remuneration, which are usually regarded as a cost of future service (and do not give rise to present obligations). They believe that in the absence of a legal or constructive obligation to increase pensionable salaries, it is not appropriate to assume that employers have an obligation to increase pensionable salaries in line with inflation.

Guaranteed increases in deferred benefits

4.57 It was noted earlier that in many jurisdictions, future increases to pensions in deferment are guaranteed by law or contract in order to provide some protection against inflation. This means that if an employee leaves service and obtains the right to a (deferred) pension that is based on his salary at the date of leaving, the deferred pension is guaranteed to grow by whatever measure is provided by law or contract.

4.58 In those circumstances, it appears that, as argued previously, the entity does not have an obligation to increase benefits that have been earned by employees who remain in service unless it has a legal or constructive obligation to increase future pensionable salaries. But when employees leave service, the entity clearly has a present obligation that includes future inflationary increases to benefits (as argued

in paragraphs 4.4-4.7 above). How should this scenario be reflected in the financial statements?

4.59 On one view, the liability at each reporting date should reflect that current employees have certain rights and former employees have different rights. The liability relating to current employees should not reflect future increases, because their accrued pension rights are not guaranteed to grow (unless the entity is committed to increasing pensionable salaries). However, the accrued pension rights of former employees are guaranteed to grow and this should be reflected in the liability to them. This means that when an employee leaves service, the liability would increase, reflecting a cost of leaving at that point.

4.60 Others believe that view takes the 'no liability' argument too far. They argue as follows. Employees receive pension benefits in exchange for services. One of those benefits is a right to inflationary increases if they leave early. In effect, the employer has written options to employees that, if they leave, they obtain a right to have their accrued benefits increased. The option to leave (and crystallise guaranteed increases) lies with the employees. That benefit is a present obligation on the employer that should be reflected in the liability. Under this view any further increase (or decrease) in the liability that arises from actual increases in pensionable salaries of employees who remain in service is recognised as an expense of the periods in which salaries are increased. The principles advocated in this Chapter would support this view.

4.61 An issue that would arise under this approach is what assumptions about leavers should be reflected in the measurement of the liability. Some believe the liability should reflect estimates of those employees that will leave and those that will stay. Others believe the liability should reflect the fact that all employees have the right to leave immediately and receive the guaranteed increases in the deferred benefits to which they would become entitled.

4.62 Those who support the second view believe that the minimum liability should reflect the employer's obligation to pay inflation increases, such as statutory indexation, on all benefits that have been earned (as if they had all left service), because they believe the employee has the vested right to those benefits. They would not reduce the liability to reflect the probability of people staying. Consequently, under that view, a decision by the employer to increase pensionable salaries of those who remain in service by less than the guaranteed inflation that is applicable to pensions in deferment would lead to a credit in the profit and loss account.

Disclosure

4.63 Some supporters of each position on the question of future salary increases believe that disclosures in financial statements should distinguish measures of liabilities 'with' and 'without' the effect of future salary increases. In their view, whichever measure is required to be reported in the balance sheet, the other measure should be disclosed because both measures provide relevant information about present and expected future obligations. Disclosure of these and other alternative measures of liabilities is discussed in Chapter 9.

Should possible modifications to terms and conditions be reflected in the liability?

4.64 Modifications to pension plans have become more frequent in recent years as many employers have sought to mitigate risks inherent in certain plans, especially final salary plans. Examples are: closures of plans (sometimes only to new members but sometimes also to the future accrual of benefits for existing employees); changing from a final salary benefit formula to a different benefit formula; changing the normal retirement age; changing the rate of employees' contributions to their benefits. In addition, modifications to plans sometimes result from new legislation – examples are: mandatory indexation of pensions when previously increases to pensions were at the employer's discretion; a reduction in guaranteed rates of increases to pensions. It is commonly the case that benefits that have been promised and earned by plan members for their past services cannot be reduced unless the members agree.

4.65 Under the view that the liability should reflect only benefits that the entity is committed to now, the contract in which pension benefits are provided would be accounted for as it is until it is changed. Modifications that relate to future service are straightforward to account for, because the liability is not changed by the modification. For example, under the view that the liability in a final salary plan only includes benefits earned based on current salaries, the effect of closing the plan to the accrual of future benefits is to reduce the reported expense for remuneration in future periods of service. Modifications relating to past service (such as mandatory indexation of pensions) would be recognised when they occur, because they give rise to different obligations than exist today (this is consistent with the view articulated in paragraph 4.18 above).

4.66 Under the view that there is only one present obligation – a contractual obligation to pay benefits for past service – of an uncertain amount (the view articulated in paragraph 4.16 above), there is another possibility. For example, under the view that the liability for past service in a final salary plan should be based on expectations of employees' pensionable salaries when they leave service, the question arises as to whether the measurement of the liability should reflect the probability that the benefits will be reduced – for example, by closing the plan to the future accrual of benefits for existing employees. In the view of some, that approach would provide the best measure of what the entity expects to pay.

4.67 Anticipating such changes does not, however, appear to be supported by other accounting standards. The approach taken in IAS 37 would preclude reflecting future events in the measurement of a present obligation unless there is sufficient objective evidence that they will occur. For example, the effects of possible new legislation are not taken into consideration in measuring an existing environmental clean-up obligation until sufficient objective evidence exists that the legislation is virtually certain to be enacted.⁸

4.68 The approach taken in the exposure draft of amendments to IAS 37 (2005) is rather different – addressing the issue as a matter of recognition rather than measurement. It proposes that the effects of

⁸ IAS 37, paragraph 50.

future events that create new obligations (or change or discharge existing obligations) are not reflected in the measurement of a liability. For example, the effects of possible new legislation are not reflected in the measurement of a liability because it is reasoned that they give rise to a new obligation (or change an existing obligation), rather than change the amount required to settle the existing obligation, when the law is substantively enacted.⁹ The same reasoning could be applied to the effects of possible modifications to pension plans, including the effects of possible new legislation on existing obligations.

4.69 This paper concludes that possible modifications to benefits are not reflected in the liability that exists today but are taken into account when they occur (when they give rise to different liabilities than have been previously reported).

5 What is the unit of account for a liability to pay pensions?

5.1 An issue in considering the liabilities that arise in the context of pensions is the unit of account: should financial reporting be based on the premise that a liability is owed to an individual employee or to the workforce as a whole?

5.2 As indicated earlier in this Chapter, present accounting standards on liabilities use words like ‘cannot realistically avoid’, ‘little, if any, discretion to avoid’ or, in the case of constructive obligations, ‘created a valid expectation’, in determining whether or not a liability exists. But to whom is the liability owed, if there is one? Is there a separate liability to each individual, or is there a liability to the workforce as a whole? Some believe that it makes a difference if some of the issues addressed in this Chapter are approached by focusing on the employer’s obligation to the workforce as a whole rather than on the obligation to an individual employee or pensioner.

5.3 Unfortunately, the ‘unit of account’ issue is not well developed in the present accounting literature – for example, the Framework gives no guidance.¹⁰ The following extract from the IASB’s Basis for Conclusions to the exposure draft of amendments to IAS 37 (July 2005) is relevant:¹¹

“The Board acknowledged that in practice many guarantees within the scope of IAS 37 would be recognised because the Standard requires entities to consider recognition by reference to a portfolio (or class) of similar obligations. Thus, although it might not be probable that a payment will arise from a single guarantee, it is probable that *some* payment will arise in a portfolio of guarantees and, therefore, a liability is recognised. However, the Board decided that resolving a troublesome recognition issue in this way (i.e. by requiring recognition on a portfolio basis) is

⁹ Exposure draft of amendments to IAS 37 (2005), paragraph 42 and BC88.

¹⁰ The IASB’s project reports note that the unit of account will be addressed later on in the Conceptual Framework project.

¹¹ Exposure Draft of Amendments to IAS 37 (July 2005), BC39.

conceptually unsatisfactory. It would be better if the probability recognition criterion could be applied consistently for single guarantees and portfolios of guarantees.”

5.4 In the context of pensions, two examples illustrate the issue. The first example relates to benefits in respect of services before vesting (this issue is discussed in Section 3 of this Chapter). Some might conclude that in some situations an employer does not have a liability to any individual employee because it could realistically avoid its obligation to an individual in a number of ways, including restructuring and redundancy. But they might also conclude that the employer cannot realistically avoid paying *some* benefits to the workforce as a whole in respect of services before vesting (except, perhaps, by closing down its entire business). In their view, there may be situations where there is no liability if the unit of account is the obligation to an individual employee, but there is a liability if the unit of account is the obligation to the workforce as a whole.

5.5 The second example relates to the level of future salaries in final salary plans (this issue is discussed in Section 4 of this Chapter). Some might conclude that in some situations there is no legal or constructive obligation to any individual employee to increase his or her pensionable salary in the future, because the employer may have the ability to avoid awarding such increases and an individual may not have a right to or valid expectation of such increases. But they might also conclude that this position is much less plausible if the focus is on the whole workforce, because in their view it would be unrealistic to argue that the employer can avoid increasing pensionable salaries of *some* of its employees during their careers.

5.6 Some consider that the focus on the whole workforce as the unit of account is economically the most relevant perspective and hence should be used as the basis for financial reporting. Under this view, some potential future cash outflows that would be recognised as liabilities might not be recognised if the unit of account is the obligation to an individual.

5.7 Others believe that using the obligation to the whole workforce as the unit of account increases confidence in the *measurement* of the liability. For example, they claim that a liability for a population of unvested benefits can be estimated more reliably than for one employee; also it is possible to be more confident about things such as the trend of salary increases. However, they do not agree that using the whole workforce rather than an individual should give rise to a different view on the *recognition* of a liability, because in their view the obligation to the whole workforce is the sum of the obligations to individuals. Under this view, if the employer does not have a legal or constructive obligation in respect of things like unvested benefits to any individual with whom it has contracted (such that no enforceable right has been conveyed), it cannot have one to the workforce as a whole.

5.8 **In summary, the unit of account is an important (and unresolved) conceptual issue that may have consequences for determining what liabilities should be recognised:**

(a) **Some believe that taking the whole workforce as the unit of account would lead to more potential future cash outflows being considered for recognition as liabilities.**

- (b) Others (including several ASB members) are troubled by that view. Their views on which potential future cash outflows should be considered for recognition as liabilities are not changed by taking the whole workforce as the unit of account; however, in their view it provides more confidence in measurement of liabilities.

6 How should benefits be attributed to periods of service?

Introduction

6.1 In Section 3 of this Chapter, it is proposed that the rendering of service is the obligating event that gives rise to a liability to pay benefits. However, to arrive at a measure of expense and additional liability for pension benefits relating to services rendered in each financial reporting period, it is necessary to define more precisely which benefits should be reflected in the liability that exists at the end of each reporting period. This raises the question of determining how the benefits earned by employees accumulate as they render service; in other words, how to attribute benefits to periods of service.¹²

6.2 The question of attributing benefits is not unique to pensions and other post-employment benefits, although their nature makes it more complex. Consider for example an employer that hires an employee on a 3-year contract with a fixed amount of salary for the 3-year period. The payment pattern would usually be level, but it need not be – some or all could be paid at the beginning or at the end. It would be generally accepted that the expense arises when the employer receives the services and not when it pays for them; therefore, a portion of the total salary has to be allocated to each financial reporting period.

6.3 In this section, the approaches in present accounting standards for attributing benefits to periods of service are reviewed and a principle is explored that could be applied to all types of pension benefits.

The present approach

6.4 The requirements of IAS 19, SFAS 87 and FRS 17 for attributing benefits to periods of service are similar and are set out in Appendix A. They reflect the distinction made between defined contribution and defined benefit plans.

¹² This discussion does not address benefits that are unrelated to length of service, such as death-in-service benefits that vest immediately when an employee starts service.

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6.5 IAS 19's requirements for attributing benefits might be summarised as follows:

Defined contribution	The amounts required to be contributed for each period of service are used to attribute an expense and additional liability
Defined benefit	<p>(e) look first to what the contract says about the benefit that is earned in each period of service and, subject to (b) and (c) below, use the benefit formula to attribute an expense and additional liability;</p> <p>(f) if benefits as specified in the contract are materially higher in later periods of service than in earlier periods, consider whether some of the benefits attributed in the contract to later periods of service should be attributed in the financial statements to earlier periods of service;</p> <p>(g) in any case, the liability at each reporting date should be measured on a basis that reflects estimated future salary increases when benefits are based on future salary levels.</p>

6.6 In Section 3 of this paper, it is proposed that benefits in respect of services provided before vesting can give rise to a liability. Most people would agree that the benefit formula alone may not provide a reliable measure of the exchange of services for benefits. The reason is that a benefit that might in substance be earned over a period of service before it vests could be dressed up as a lump sum benefit that is not earned until it vests after a period of service (see example from SFAS 87 quoted in paragraph A6 of Appendix A).

6.7 However, the approach in IAS 19 gives rise to some issues, such as:

- (a) why do the requirements for defined contribution plans and defined benefit plans differ and how do they relate to each other and to other types of plans that are not clearly defined contribution or defined benefit (such as cash balance plans)?

- (b) for defined benefit plans, what is the principle behind the requirement to over-ride the benefit formula and to attribute benefit on a straight-line basis *when an employee's service in later years will lead to a materially higher level of benefit than in earlier years*, and should it apply also to other types of plans?
- (c) is the requirement in (b) inconsistent with the way we account for other types of remuneration, such as salaries, that are expected to be higher in later years of service than in earlier years?
- (d) is the requirement in (b) one-sided, because it requires liabilities to be accrued when benefits are higher in later years, but does not require assets (prepayments for services not yet received) when benefits are higher in earlier years?

Examples

6.8 It is useful to work with some examples. Example 10 (see paragraph 4.33), which is based on an example accompanying IAS 19, illustrates the required 'projected unit credit' method to determine the liability and service cost for each reporting period in a simple final salary plan.

6.9 In Example 10:

- Column B of Table 1 shows the method of attributing benefits required by IAS 19 – the total expected benefit (including the effect of salary increases until the end of the employee's career) is projected forward and attributed to periods of service on a straight-line basis.
- Column A shows a method of attributing benefits that would be preferred by those who believe the liability and service cost for each reporting period should not reflect an expected level of future pensionable salaries – instead, when salaries are increased, the re-pricing of the benefits that have been earned in the past is treated as an expense of the period when the salary is increased.

6.10 The following examples are variations of Example 10 and cover the spectrum of benefits:

- (a) career average salary plan (Example 11)
- (b) current salary plan (Example 12)
- (c) defined contribution plan (Example 13)
- (d) cash balance plan (Example 14)

Career average salary plan

6.11 Example 11 is the same as Example 10, except that the benefit is expressed as 10% of the employee's career average salary for each year of service.

Example 11

A lump sum benefit is payable on termination of service and equal to 10% of the average salary for each year of service. The salary in year 1 is 10,000 and is assumed to increase at 7% (compound) each year.

The benefit attributed to each year for an employee who is expected to leave at the end of year 5 is set out in Table 2:

- Column A shows the benefit attributed according to the benefit formula and is based on the average salary for the employee's career to date (current average salary). Under this method, the liability at each reporting date is equal to 10% of the average salary to date for each year of service – for example, in year two the liability of 2,070 is 10% of 10,350, being the average salary to date $(10,000+10,700)\div 2$, $\times 2$ years of service. The expense for each reporting period is equal to the increase in the liability.
- Column B shows the method of attribution required by IAS 19, i.e. the total benefit based on the expected average salary at the end of the employee's career is projected forward and attributed to periods of service on a straight-line basis. Thus 10% of the expected career average salary of 11,501 (1,150) is attributed to each year of service.

Table 2*Career average salary plan*

Year	Salary	Average salary to date at year end	Benefit attributed			
			A		B	
			Current average salary		Expected average salary at end of employee's career (IAS 19)	
			Current period	Liability accumulated	Current period	Liability accumulated
1	10,000	10,000	1,000	1,000	1,150	1,150
2	10,700	10,350	1,070	2,070	1,150	2,300
3	11,449	10,716	1,145	3,215	1,150	3,450
4	12,250	11,100	1,225	4,440	1,150	4,600
5	13,107	11,501	1,310	5,750	1,150	5,750
			5,750		5,750	

6.12 The total projected benefits are lower in Example 11 than in Example 10 – the final salary plan is more valuable than the career average plan because it is assumed that there are identical salary increases.

6.13 To summarise, Column B is the method of attribution required by IAS 19. Some who believe that future salary increases should be reflected in a final salary plan also believe that they should be reflected in a career average salary plan because, in their view, the employer has a present obligation to pay for past service that is based on the level of future pensionable salaries and, hence, each increase in pensionable salary results in the re-pricing of the benefits that have been earned in the past.

6.14 Those who believe that the liability and service cost for each reporting period in a final salary plan should not reflect an expected level of future pensionable salaries would support the method in Column A.

Current salary plan

6.15 Now consider a current salary plan. Example 12 is the same as Example 11, except that the benefit is 10% of the salary earned in each year of service.

Example 12

A lump sum benefit is payable on termination of service and equal to 10% of the salary earned in each year of service. The salary in year 1 is 10,000 and is assumed to increase at 7% (compound) each year.

The benefit attributed to each year for an employee who is expected to leave at the end of year 5 is set out in Table 3:

- Column A shows the benefit attributed according to the benefit formula. Under this method, the benefit attributed to each year of service is equal to 10% of the salary earned in that year.
- Column B shows the benefit attributed on a straight-line basis, i.e. reflecting expected future salary increases. Under this method, the total benefit expected to be earned in the employee's career is projected forward and allocated on a straight-line basis to each period of service.

Table 3*Current salary plan*

Year	Expected salary	Benefit attributed			
		A		B	
		Per benefit formula		Straight-line basis	
		Current period	Liability accumulated	Current period	Liability accumulated
1	10,000	1,000	1,000	1,150	1,150
2	10,700	1,070	2,070	1,150	2,300
3	11,449	1,145	3,215	1,150	3,450
4	12,250	1,225	4,440	1,150	4,600
5	13,107	1,310	5,750	1,150	5,750
		5,750		5,750	

6.16 A question that has arisen (and been recently considered by the IASB's International Financial Reporting Interpretations Committee (IFRIC)) in relation to plans with a benefit formula expressed in terms of *current salary* is whether expected increases in salary should be taken into account in determining whether the benefit formula will lead to a materially higher level of benefit in later years. In relation to Example 12, the question concerns whether the method in Column B should be used rather than the method in Column A, because of the requirement in IAS 19 to override the benefit formula if employees' service in later years will lead to a materially higher level of benefit than in earlier years. Benefits are expected to be higher in later years because salary levels are expected to increase materially. Under the method in Column B, the total benefit based on expected future salaries is projected forward and attributed to periods of service on a straight-line basis.¹³

¹³ This issue is still unresolved. The IFRIC decided in September 2007 to remove it from its agenda, noting that it would be difficult to address this issue while the IASB had an ongoing project that addressed the issue for some defined benefit plans.

6.17 Those who believe that the liability and service cost for each reporting period in a final salary plan should not reflect an expected level of future pensionable salaries would support the method in Column A.

6.18 It may be surmised that some who support the status quo on reflecting expected future salary increases (Column B in Table 1 (Example 10) and Column B in Table 2 (Example 11)) would support Column B in Table 3 (Example 12) because they would argue that the methods are consistent.

6.19 It is noteworthy that the two methods of attribution in Columns A and B of Table 3 give exactly the same patterns of expense and liability accumulation as in Table 2. That is perhaps unsurprising because, although the benefits in the two plans are expressed differently, they are economically the same. A benefit of 10% of the salary earned in each year of service is the same as the benefit of 10% of the average salary multiplied by the number of years' service.

6.20 This helps to explain why some would support the treatment in Column B of Table 3 in Example 12 for a current salary plan – it stems from IAS 19's requirement to measure defined benefit obligations on a basis that reflects estimated future salary increases. In their view, which does not seem unreasonable, the liability and the service cost in each period for the plans in Examples 11 and 12 should be the same because the benefits are the same.

6.21 Others believe that it is illogical for future salaries to be reflected in the reporting of either type of plan. If they are, they would question whether it is inconsistent not to use the same approach across the spectrum of benefits, including plans where the benefit is of the defined-contribution type (see Example 13).

Defined contribution plan

6.22 Example 13 is the same as Example 12, except that the benefit is a contribution to a plan of 10% of the salary earned in each year of service.

Example 13

The benefit is an annual contribution payable to a plan equal to 10% of the salary earned in each year of service. The salary in year 1 is 10,000 and is assumed to increase at 7% (compound) each year.

The benefit attributed to each year for an employee who is expected to leave at the end of year 5 is set out in Table 4:

- Column A shows the benefit attributed according to the benefit formula. Under this method, the benefit attributed to each year of service is equal to 10% of the salary earned in that year.

- Column B shows the benefit attributed on a straight-line basis, i.e. reflecting expected future salary increases. Under this method, the total benefit expected to be earned in the employee's career is projected forward and allocated on a straight-line basis to each period of service.

Table 4*Defined contribution plan*

Year	Expected salary	Benefit attributed			
		A		B	
		Per benefit formula (IAS 19)		Straight-line basis	
		Current period	Liability accumulated	Current period	Liability accumulated
1	10,000	1,000	-	1,150	150
2	10,700	1,070	-	1,150	230
3	11,449	1,145	-	1,150	235
4	12,250	1,225	-	1,150	160
5	13,107	1,310	-	1,150	-
		5,750		5,750	

6.23 To summarise, Column A is the method of attribution required by IAS 19. The approach in Column B would be used if IAS 19's requirements for defined benefit plans were applied to defined contribution plans.

Cash balance plan

6.24 Finally, consider an example of a cash balance plan. In a cash balance plan, the employer's obligation is to provide a pot of money to the employee at retirement. The benefit is usually expressed by reference to a notional account balance which comprises a notional contribution equal to a specified percentage of salary (it could be current, average or final salary) and a specified return on those contributions (for example, a specified rate of interest or a return equal to the yield on long-term bonds).

Example 14

A lump sum benefit is payable on termination of service and equal to a notional contribution of 10% of the salary earned in each year of service, together with interest of 5% on the accumulating account balance. The salary in year 1 is 10,000 and is assumed to increase at 7% (compound) each year.

The benefit attributed to each year for an employee who is expected to leave at the end of year 5 is set out in Table 5:

- Column A shows the benefit attributed according to the benefit formula. Under this method, the benefit attributed to each year of service is equal to the notional contribution of 10% of the salary earned in that year, plus interest at 5% on the accumulating balance.
- Column B shows the benefit attributed on a straight-line basis, i.e. reflecting expected future salary increases. Under this method, the total benefit expected to be earned in the employee's career is projected forward and allocated on a straight-line basis to each period of service.

Table 5

Cash balance plan

Year	Expected salary	Benefit attributed				
		A				B
		Per benefit formula				Straight-line basis
		Notional contribution	Interest (see note)	Total current period	Liability	Current period
1	10,000	1,000	25	1,025	1,025	1,294
2	10,700	1,070	78	1,148	2,173	1,294
3	11,449	1,145	137	1,282	3,455	1,294
4	12,250	1,225	203	1,428	4,883	1,294
5	13,107	1,310	277	1,587	6,470	1,294
		5,750	720	6,470		6,470

Note: The interest added to the notional contributions for each period has been calculated simply as (a) 5% of the liability at the beginning of the year, plus (b) 5% of one half of the notional contributions for the period.

6.25 It is interesting to note that the FASB's Emerging Issues Task Force (EITF) considered the accounting for cash balance plans such as the above in 2003. EITF Abstract 03-04 (paragraph 5) includes the following consensus:

"The Task Force reached a consensus on Issue 2 that the benefit promise in the cash balance arrangement is not pay-related as contemplated by Statement 87 and its related interpretative guidance. Accordingly, use of a projected unit credit method is neither required nor appropriate for purposes of measuring the benefit obligation and annual cost of benefits earned under Statement 87. The appropriate cost attribution approach, therefore, is the traditional unit credit method."

6.26 The traditional unit credit method referred to in the EITF consensus does not take into account expected future salaries. Hence it would result in benefit being attributed according to the benefit formula (Column A in Table 5) rather than the straight-line method in Column B.

6.27 Some would question whether, if the plan in Example 14 is not 'pay-related', are the plans in Examples 11 and 12 in any sense more pay-related? Or, put the other way round, how is the plan in Example 14 or, for that matter, the plan in Example 13, in any sense less 'pay-related' than the others? They all have a benefit (or contributions) expressed as a percentage of salary. Some believe there is an inconsistency if in some cases, and not others, benefits attributed in the contract to later periods of service are attributed in the financial statements to earlier periods of service.

What conclusions can we draw?

6.28 The conclusion can be drawn from the above discussion that the present requirements are unsatisfactory because there is no clear principle behind them. For example, the requirements to (a) reflect future salary increases and (b) revert to a straight-line basis when the benefits are materially higher in later years than in earlier years do not work consistently across the spectrum of benefits. And it does not follow that, if an employee expects to earn materially higher benefits in later years, that the employee has a present right, or the employer has a present obligation, in respect of any portion of those future benefits.

6.29 The present requirements also seem to lose sight of a fundamental question, which is: what is the present obligation at the reporting date? In Section 3 of this Chapter, it is proposed that there is a present obligation for:

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- (a) vested pension benefits; and
- (b) benefits in respect of services provided before vesting, if the employer has an obligation that it cannot realistically avoid.

6.30 Because benefits that vest immediately as services are rendered are recognised immediately as liabilities, the main point at issue is to identify benefits in respect of services provided before vesting. In this regard, benefits are considered not to have vested if an employee has to continue in employment to become entitled to benefits that are linked to increases in pensionable salaries.

6.31 If Examples 10 to 14 were considered from the perspective of whether or not there is at the end of each reporting period a present obligation in respect of benefits that have not vested, the suggested response is given in the following table.

Example	Plan type	Is there a present obligation in respect of services provided before vesting?
10	Final salary	Two views (see Section 4)
11	Career average salary	Two views (see para 6.33)
12	Current salary	No
13	Defined contribution	No
14	Cash balance	No

6.32 No contributors to this paper have supported recognising the existence of a present obligation for benefits that have not vested (and, hence, for the straight-line spreading type of method) in Examples 12, 13 or 14. They do not believe there is a present obligation for any part of the remuneration (the salaries or the pension benefits that are based on the salaries) that is expected to be paid for future service. Put another way, expected salary increases over an employee's career are not reflected in financial statements by smoothing them over the employee's service life and it is not clear why pension benefits should be treated differently.

6.33 As noted in paragraph 6.13, some who believe that future salary increases should be reflected in a final salary plan also believe that they should be reflected in a career average salary plan; they would use the same approach across the whole spectrum of benefits that are based on final or average salaries.

Others would only take that view for final, or final average salary plans.

6.34 Of course, it is recognised that the terms of any of the plans could be modified so as to give rise to a delayed vesting of benefits, with the substance of an unvested benefit for past service, even the plans of defined-contribution type. For example, if in the defined contribution plan in Example 13, instead of a contribution of 10% in years 1 and 2, an extra contribution of 20% was payable in year 3, conditional on the employee completing 2 years' service, the approach advocated in this paper would result in recognising the existence of a present obligation in respect of the employee's service in years 1 and 2. Furthermore, it would result in a consistent approach to identifying present obligations for unvested benefits in any type of plan.

6.35 The following approach attempts to address the liability question in a more principled way than the present requirements :

- (a) consider what the contract says about the benefit that is earned in each period of service and, if benefits vest immediately, recognise a liability and (subject to (c)) an expense when the benefits vest;**
- (b) consider whether the substance of the contract is that, in addition to benefits that have vested, a present obligation also arises in respect of services provided before vesting. If it is, recognise a liability and expense as employees render service during the period until the benefits vest;**
- (c) in relation to benefits that have vested, consider whether the substance of the contract is that an asset arises reflecting a prepayment for services to be provided after vesting¹⁴.**

¹⁴ This principle is included for completeness, but it is not expected that an asset would arise often.

7 Summary

7.1 Liabilities, as defined in the *Framework* arise when there is a present obligation to transfer economic benefits. This Chapter sets out views on which possible future pension benefits are (or are not) present obligations and should therefore be (or not be) reflected in the reported liability to provide pension benefits.

7.2 Pension obligations arise under employment contracts in which pension benefits are provided in exchange for services. It is at the time at which services are provided that a liability arises. (Paragraphs 3.1-3.12)

7.3 The liability that arises when service is provided includes, in addition to vested benefits, benefits in respect of services provided before vesting, because an employer cannot realistically avoid his promise (or can cancel it only on payment of compensation). (Paragraphs 3.13-3.30)

7.4 The liability that arises is often subject to a number of uncertainties, including those relating to future prices and other economic factors and demographic factors such as mortality: many of these clearly are relevant to the measurement of a liability, not whether it exists. (Paragraph 2.15)

7.5 It is less clear whether some other factors, including benefits that the employer has discretion to vary and the level of future pensionable salaries, concern the measurement of a liability or its existence. There should be a clear principle that provides a basis for determining whether an entity has a liability for benefits that it might become committed to in the future: (Paragraph 2.16)

Some believe all expected payments in relation to past service, including benefits that the entity might become committed to in the future, should be reflected in the liability. (Paragraphs 4.16-4.17)

This paper concludes that only benefits that the entity is presently committed (by legal or constructive obligation) to pay should be reflected in the liability. (Paragraphs 4.18-4.24)

7.6 Consequently, a liability in respect of pensions includes increases that are guaranteed by law or contract, and also those that an entity has a constructive obligation to provide. However, only benefits to which the entity is presently committed 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 reported liability should also not reflect possible future changes to the entity's or the plan's financial position. (Paragraphs 4.4-4.12; 4.25-4.30)

7.7 For benefit designs that link the amount of benefits to the employees' salaries at or near retirement or leaving service, the requirement to include the effect of expected future salary increases in the liability that is recognised during service should be reconsidered. Alternative views have coalesced around two positions: (Paragraphs 4.31-4.63)

- Some believe that the liability to pay benefits that is recognised (and the pension expense for each period) should be based on expectations of employees' pensionable salaries when they leave service.
- Others (including a majority of the ASB's members) believe that the liability to pay benefits that is recognised (and the pension expense for each period) should be based on the benefits that the employer is presently committed to provide – this would usually be benefits based on current salaries plus any increases that are required by law or contract and would include other increases that are seen as non-discretionary, i.e. in respect of which there is a constructive obligation. Under this view, the pension expense of each period will reflect the extra pension liability incurred by giving increases in pensionable salaries.

7.8 An issue in considering the liabilities that arise in the context of pensions is the unit of account: should financial reporting be based on the premise that a liability is owed to an individual employee or to the workforce as a whole? It may be reasonably clear that an employer can realistically avoid incurring an obligation, such as that for future salary increases, to an individual employee, but doubtful whether the employer can realistically avoid it for the entire workforce. (Section 5)

7.9 The present requirements for attributing benefits to periods of service in defined contribution plans and defined benefit plans are unsatisfactory because there is no clear principle behind them that can be applied consistently across the spectrum of benefits. The focus should shift from mechanisms that spread pension costs over employees' service lives to the principle of reflecting only present obligations as liabilities. (Section 6)

Present accounting standards

A1 The requirements of IAS 19, SFAS 87 and FRS 17 for attributing benefits are set out below.

IAS 19 'Employee Benefits'

Defined contribution plan

A2 IAS 19 requires the contribution payable to a defined contribution plan in exchange for employee service to be recognised as a liability and expense when the employee has rendered service. Contributions paid are deducted from the liability or, if paid in advance, are recognised as an asset. (Paragraph 44)

Defined benefit plan

A3 The first step in accounting for defined benefit plans is “using actuarial techniques to make a reliable estimate of the amount of benefit that employees have earned in return for their service in the current and prior periods. This requires an entity to determine how much benefit is attributable to the current and prior periods.....” (Paragraph 50(a))

A4 The following requirements ensue:

- the Projected Unit Credit Method is used to determine the present value of defined benefit obligations and related current service cost and, where applicable, past service cost. (Paragraph 64)
- benefit is attributed to periods of service according to the plan’s benefit formula, except when an employee’s service in later years will lead to a materially higher level of benefit than in earlier years, in which case benefit should be attributed on a straight-line basis. (Paragraph 67)
- post-employment benefit obligations are measured on a basis that reflects estimated future salary increases. (Paragraph 83)

SFAS 87 'Employers' Accounting for Pensions'

Defined contribution plans

A5 “To the extent that a plan’s defined contributions to an individual’s account are to be made for periods in which that individual renders services, the net pension cost for a period shall be the contribution called for in that period.” (Paragraph 63)

Single-employer defined benefit pension plans

A6 SFAS 87’s requirements for attributing benefits are summed up in the following extracts:

“The Board believes that the terms of the plan that define the benefits an employee will receive (the plan’s benefit formula) provide the most relevant and reliable indication of how pension cost and pension obligations are incurred. In the absence of convincing evidence that the substance of an exchange is different from that indicated by the agreement between the parties, accounting has traditionally looked to the terms of the agreement as a basis for recording the exchange. Unlike some other methods previously used for pension accounting, the method required by this Statement focuses more directly on the plan’s benefit formula as the basis for determining the benefit earned, and therefore the cost incurred, in each individual period.” (Summary)

“Some plans may have benefit formulas that attribute all or a disproportionate share of the total benefits provided to later years of service, thereby achieving in substance a delayed vesting of benefits. For example, a plan that provides no benefits for the first 19 years of service and a vested benefit of \$10,000 for the 20th year is substantively the same as a plan that provides \$500 per year for each of 20 years and requires 20 years of service before benefits vest. For such plans the total projected benefit shall be considered to accumulate in proportion to the ratio of the number of completed years of service to the number that will have been completed when the benefit is first fully vested.” (emphasis added) (Paragraph 42)

A7 SFAS 87 requires the projected benefit obligation to be measured using an assumption as to future compensation levels if the pension benefit formula is based on those future compensation levels. These include pay-related, final-pay, final-average-pay and career-average-pay plans. (Paragraph 17)

FRS 17 'Retirement Benefits'

Defined contribution schemes

A8 “The cost of a defined contribution scheme is equal to the contributions payable to the scheme for the accounting period.” (Paragraph 7)

Defined benefit schemes

A9 Defined benefit scheme liabilities are measured using the projected unit method and benefits are “attributed to periods of service according to the scheme’s benefit formula, except where the benefit formula attributes a disproportionate share of the total benefits to later years of service. In such cases, the benefit should be attributed on a straight-line basis over the period during which it is earned.”
(Paragraphs 20, 22)

A10 In the case of pensions based on final salary, the liability is based on the expected final salary.
(Paragraph 28(b))

Chapter 3: Assets and liabilities – reporting entity considerations

1 Introduction

1.1 Financial statements contain information about resources controlled by an entity and claims on those resources. What resources and claims are included in and excluded from financial statements is determined by the boundary of the reporting entity, i.e. the boundary of the individual reporting entity (for an entity's *individual* financial statements) and the boundary of the group (for an entity's *consolidated* financial statements).

1.2 Ideally the financial statements of each reporting entity should report assets that are representative of its resources and liabilities that are representative of its obligations to the members of a plan and, where applicable, to other entities that are party to a plan.

1.3 Three broad families of pension arrangements are:

- (a) members of a plan have a claim on the employer for payment of their pensions, and no assets are set aside by the employer to provide funds for their payment;
- (b) members of a plan have a claim on a separate pension provider, such as an insurance company, with the employer agreeing to contribute to the plan as services are provided;
- (c) assets are set aside by the employer to provide funds for the payment of benefits, and members of the plan have a claim on the employer or on a pension trust or similar entity established by the employer.

1.4 Put simply, liabilities to pay benefits could be:

- liabilities of the employer (in the *individual* financial statements);
- liabilities of another entity (e.g. a separate pension provider or an employer-sponsored trust);
- liabilities of the employer's group – (in the *consolidated* financial statements – if they were liabilities of another entity that was accounted for as if it were a subsidiary of the employer).

1.5 Similarly, assets held to pay benefits could be:

- assets of the employer (in the *individual* financial statements);
- assets of another entity (e.g. a separate pension provider or an employer-sponsored trust);
- assets of the employer's group – (in the employer's *consolidated* financial statements – if they were assets of another entity that was accounted for as if it were a subsidiary of the employer).

1.6 Existing financial reporting standards in effect provide a blanket exemption from reporting pension plans on a consolidated basis in employers' *consolidated* financial statements. Instead, a net asset or liability is reported in respect of any surplus or deficit in the plan that is attributable to the employer.

1.7 This Chapter sets out views on:

- how assets and liabilities might be defined in the *individual* financial statements of the employer (and, where applicable, in the financial statements of other entities that are party to an arrangement for the provision of pension benefits) (Section 2)
- whether the exemption from reporting pension plans on a *consolidated* basis remains appropriate (Section 3)

2 Individual financial statements

2.1 Chapter 2 sets out views on which elements of the promise of a pension meet the definition of a liability, without addressing the question of which entity (or entities) has the liability.

2.2 This section discusses the identification of assets and liabilities in the following scenarios, which correspond to the families of pension arrangements described in 1.3 above:

- (a) claim on the employer, no assets set aside;
- (b) claim on a separate pension provider;
- (c) assets are set aside to provide funds for the payment of benefits.

2.3 As regards assets held to provide funds for the payment of benefits, a question is whether contributions paid by the employer to another entity or fund result in the transfer of assets from the employing entity.

Claim on the employer, no assets set aside

2.4 The promise of a pension is a form of deferred remuneration for services provided by employees.

2.5 If the employing entity is directly responsible for paying the benefits promised to employees, the liability must rest directly with the employing entity.

2.6 The assets and liabilities that are representative of the parties' rights and obligations are as follows:

	Assets	Liabilities
<i>Members</i>	Claim against the employing entity for right to receive benefits	
<i>Employing entity</i>		Obligation to plan members to pay their benefits

Claim on a separate pension provider

2.7 There is a family of arrangements in which employees have contracts with other entities that provide pension benefits. An example is a personal pension contract with an insurance company.

2.8 As part of the contract of employment, the employer gives the employee the right to participate in such a plan and agrees to contribute to it. The contributions are invested by the pension provider on the employee's behalf and the assets accumulated from the contributions are later used to provide benefits, e.g. by purchasing an annuity or providing a lump sum.

2.9 In some arrangements the plan may be a plan of the employee's choice. In other arrangements the employer will facilitate the plan in the sense that it designates a plan that the employee can join and arranges the employee's membership of the plan. However, a defining feature is the existence of a contract between the employee and the pension provider.

2.10 In a personal contract based plan, the vehicle through which the assets are accumulated may be a trust or similar entity, but if it is, the trust is established by the third party entity rather than the employing entity.

2.11 When an employee has a contract with another entity that provides pension benefits, the employee will have a claim on that entity. Conversely, that entity is under contract with the employee and is directly responsible for paying the benefits promised to the employee. In those circumstances it seems clear that the liability to pay benefits is a liability of the pension provider.

2.12 It also seems clear that the payment of contributions by the employer to the pension provider results in the transfer of assets to the pension provider, because the pension provider controls the resources held to provide the funds for the payment of benefits.

2.13 Where a pension is provided by a third party (such as an insurance company) some or all of the employer's present obligation to the employee is extinguished by transferring assets (i.e. paying agreed contributions) to the third party.

2.14 In a pure money purchase (or defined contribution) plan, the employer has an obligation to make contributions to each employee's individual fund according to the terms of its contract with the employee. If the employer has no further obligations, its liabilities are settled when the agreed contributions are paid. In other words, there is no liability except for unpaid contributions.¹

2.15 A question arises whether the employer has any further obligations (legal or constructive) that might give rise to liabilities. The liability of the employer will be influenced by its own actions, law and contract conditions that apply in each situation.

2.16 If the employment contract is explicit that the employer has indicated that it will accept no responsibilities in relation to the arrangement between the employee and the pension provider, the possibility of any liability arising on the employer (other than for the obligation to pay contributions for past service) may be remote.

2.17 Some plans, however, convey other obligations to the employer, in particular relating to guaranteeing a minimum rate of return on contributions invested by and on behalf of employees. In some cases, there is an explicit guarantee. In other cases, a legal or constructive obligation might be implied from the arrangement. For example, if the employer has taken a significant role in the employee's pension or investment choice, an obligation could exist to compensate employees for poor investment performance or default by an employer-chosen pension provider. Such circumstances may give rise to additional liabilities.

¹ If payment is made to the pension provider in advance of the liability arising, it will be a prepayment for services not yet received.

2.18 The assets and liabilities that are representative of the parties' rights and obligations are as follows:

	Assets	Liabilities
<i>Members</i>	Claim against the pension provider for right to receive benefits (A) <i>Possibly</i> , claim relating to other responsibilities (C)	
<i>Pension provider</i>	Assets invested in the plan Claim for unpaid contributions in respect of services provided (B)	Obligation to plan members to pay their benefits (A)
<i>Employing entity</i>		Obligation for unpaid contributions in respect of services provided (B) <i>Possibly</i> , obligation relating to other responsibilities (C)

Assets are set aside to provide funds for the payment of benefits

2.19 In many arrangements for the provision of retirement benefits, assets are set aside to provide security for promised benefits and funds for their payment. In some arrangements assets are held in a separate trust or similar entity; in other arrangements assets are held by the employing entity itself.

2.20 Funding of liabilities, often through the vehicle of trusts, is necessary because there are no long-term guarantees of corporate success or existence. Indeed, the average life of some business enterprises may be shorter than the duration of their retirement benefit obligations. Another important reason is that there are sometimes tax advantages in using separate vehicles such as trusts.

2.21 When liabilities are backed by segregated assets, beneficiaries do not need to rely as much on the employer's covenant for security of their promised benefits as they would if the liabilities were unfunded. In other words, the beneficiaries have some protection from the risk of the employer becoming insolvent and there being insufficient resources available to pay the promised benefits. In many jurisdictions, governments have introduced legislation that regulates levels of funding to provide security for benefits.² In some countries, assets are required by law to be held in separate trusts or similar entities.

² For example, countries in the EU require technical provisions to be established as a basis for determining levels of funding.

The financial reporting of pensions

2.22 Assets invested to provide funds for payment of benefits might be:

- held within the employing entity, or
- transferred from the employer to an employer-sponsored trust (or similar entity).

Assets held within the employing entity

2.23 An employer that has promised pension benefits may invest in assets that are intended to provide funds for their eventual payment.

2.24 It seems clear that setting aside a collection of assets does not result in the transfer of assets to any another entity.

2.25 Furthermore, setting aside a collection of assets does not relieve the entity of its obligation. The employing entity is directly responsible for paying the benefits promised to employees. The liability must therefore rest directly with the employing entity. That is irrespective of whether separate assets are held which the entity intends to use to settle the liability.

2.26 **Where a fund of assets is established which is not transferred to a separate entity (i.e. it is simply a collection of assets of the employing entity):**

- **the assets held in the fund are reported as assets of the employing entity in its individual financial statements; and**
- **the obligation to pay benefits is a liability of the employing entity (i.e. it is not a liability of any other reporting entity).**

2.27 The assets and liabilities that are representative of the parties' rights and obligations are as follows:

	Assets	Liabilities
<i>Members</i>	Claim against the employing entity for right to receive benefits	
<i>Employing entity</i>	Assets invested	Obligation to plan members to pay their benefits

Assets are transferred from the employer to an employer-sponsored trust

2.28 The main focus is on the family of arrangements where some form of separate fund (usually a trust or similar entity) is established by the employing entity.³

2.29 Possible representations of assets and liabilities in the employing entity's individual financial statements are:

- The assets held by the trust or other entity, and the liability to pay benefits, are considered to be assets and liabilities of the employing entity.
- The liability to pay benefits is considered to be a liability of the employing entity and, separately, it has an asset representing a right to reimbursement from the trust.
- A net asset or liability – showing the net effect of the employing entity's rights and obligations in relation to the trust.

2.30 If it is concluded that an employer-sponsored trust or other entity lacks the substance of a separate entity for financial reporting purposes, the assets held by it, and the liability to pay benefits, would be considered to be in substance assets and liabilities of the employing entity.

2.31 If it is concluded that a trust or other vehicle is a separate entity for financial reporting purposes, that conclusion does not address the question of what exactly are the rights and obligations of the parties involved and, hence, what assets and liabilities arise. The assets and liabilities of that entity would not be reported as assets and liabilities of the sponsoring employer, although the entity could fall to be consolidated in the employer's consolidated financial statements (this issue is addressed in Section 3 of this Chapter).

2.32 The analysis depends on whether:

- the employer has a direct obligation to pay benefits, or
- the trust has an obligation to pay benefits and the employer has an obligation to support the trust.

³ This Chapter is written in the context of plans that are sponsored by a single employing entity. Multi-employer plans are considered in Chapter 10.

The financial reporting of pensions

2.33 The relationships between the employer, the trust and the members in respect of the obligation to pay benefits and the right to obtain benefits from trust assets depends on the legal position, such as the interaction of the constitution of the trust and the law, and this varies from country to country.

Employer has direct obligation to pay pension benefits

2.34 When the employing entity has the obligation to pay retirement benefits, the assets and liabilities that are representative of the rights and obligations appear to be as follows:

	Assets	Liabilities
<i>Members</i>	Claim against the employing entity for right to receive benefits (A)	
<i>Trust</i>	Assets invested	Obligation to reimburse the employing entity (B)
<i>Employing entity</i>	Right to reimbursement from the trust (B)	Obligation to plan members to pay their benefits (A)

2.35 This treatment is analogous to the accounting treatment for certain funds that are addressed in IFRIC Interpretation 5 'Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds'. IFRIC 5 addresses decommissioning, etc funds that have both of the following features:

- the assets are administered separately (either by being held in a separate legal entity or as segregated assets within another entity); and
- a contributor's right to access the assets is restricted.

2.36 IFRIC 5 requires that the contributor shall recognise its obligation to pay decommissioning costs as a liability and recognise its interest in the fund separately unless the contributor is not liable to pay decommissioning costs even if the fund fails to pay.

2.37 The reasons given in IFRIC 5 for that requirement include the following points:

- there is no legally enforceable right to set off the rights under the decommissioning fund against the decommissioning liabilities;

- if the fund does not assume the obligation for decommissioning, at best, the fund acts like an in-substance defeasance that does not qualify for derecognition of the liability.⁴

2.38 **The analysis suggests that if the employer has the legal or constructive obligation to pay benefits, it will have a liability to pay benefits and also an asset, representing its right to reimbursement from the plan.**

Employer has an obligation to support the trust

2.39 When the trust assumes the obligation to pay benefits and the employer has an obligation to support the trust to enable it to meet its obligations, the assets and liabilities that are representative of the rights and obligations appear to be as follows.

	Assets	Liabilities
<i>Members</i>	Claim against the trust for right to receive pension benefits (A)	
<i>Trust</i>	Assets invested Right to call for contributions from the employing entity to the extent that the trust's obligations cannot be met from the trust's own assets (B)	Obligation to plan members to pay their benefits (A) <i>Possibly</i> , an obligation to return a surplus to the employer to the extent that the trust's own assets exceed its obligations (C)
<i>Employing entity</i>	<i>Possibly</i> , a right to call for a return of surplus from the trust to the extent that the trust's own assets exceed its obligations (C)	Obligation to the trust to the extent that the trust's obligations cannot be met from the trust's own assets (B)

2.40 This analysis would include the following type of arrangement:

- An employee's contract with the employing entity gives the employee the right to join an employer-sponsored plan.

⁴ This principle is reflected in IAS 39 AG59 which states: "Payment to a third party, including a trust (sometimes called 'in-substance defeasance'), does not, by itself, relieve the debtor of its primary obligation to the creditor, in the absence of legal release."

- By becoming a member of the plan, the employee becomes entitled to receive the benefits provided by the plan.
- The sponsoring employer is required (by interaction of the legal instrument under which the plan is established and the law) to pay contributions to the trust to enable the trust to pay the benefits promised by the plan.

2.41 The analysis suggests that if the plan assumes the obligation to pay benefits and the employer has an obligation to make contributions to the trust to the extent that the plan's obligations cannot be met from its own assets, the asset or liability that is properly representative of the employer's rights and obligations is a net asset or liability that reflects its right to benefit from a surplus or its obligation to contribute to a deficit.

2.42 A surplus gives rise to an asset if the employing entity has a right to benefit from it through a right to obtain a refund from the plan or a right to use the surplus to defray contributions in respect of future service benefits. In many plans, the employer's right to recover any surplus that might exist in the plan is not comparable to its obligation to pay for any deficit that might exist, because restrictions are sometimes imposed by law or contract on the recovery of surplus assets. If the employer's rights are restricted, the effect of the restrictions is reflected in the measurement of the asset.

Gross or net presentation reflects the nature of the employer's obligation

2.43 Some would object to the different outcomes suggested in paragraphs 2.38 and 2.41 where, in one set of scenarios, gross amounts of assets and liabilities would be shown on the employer's balance sheet and, in another set of scenarios, a net amount would be shown. In their view, the accounting treatments are significantly different but in some cases the economic substance of the arrangements is not very different – the employer's residual exposure could be similar whether the employer or the trust that the employer sponsors is the primary obligor to the members of the plan.

2.44 The question of offsetting assets and liabilities is one that bedevils accounting in other areas. Where it arises, accounting standard setters have decided that it does matter which entity has the obligation. For example, IAS 32 precludes offsetting financial assets and financial liabilities unless the debtor has a legally enforceable right to set off the recognised amounts (and intends to settle on a net basis) and has, in effect, only a single asset or liability – this is not achieved when assets are set aside in trust for the purpose of discharging an obligation without those assets having been accepted by the creditor in settlement of the obligation.⁵

2.45 The present requirements of IAS 19 make an exception by not requiring the usual offsetting criteria to be met when the employer retains the obligation to pay benefits. Before it was revised in 2000, the definition of plan assets in IAS 19 (revised 1998) included the following condition: "to the extent that

⁵ IAS 32, paragraphs 42-50.

sufficient assets are in the fund, the entity will have no legal or constructive obligation to pay the related employee benefits directly". Applying that definition to the situation described in paragraphs 2.39-2.41 above would have precluded a net presentation. The IASC adopted a revised definition in 2000 which removed that condition and adopted in its place a restriction that the fund "exists solely to pay or fund employee benefits". The IASC's reasoning for making that change to allow a net presentation to be used more widely includes the view that "the restrictions on the use of the assets creates a sufficiently strong link with the employee benefit obligations that a net presentation is more relevant than a gross presentation, even if the entity retains a direct obligation to the employees". However, it also acknowledges that it is 'inconsistent' with derecognition and offsetting requirements in other standards, a 'pragmatic exception' to its general offsetting criteria and that the new definition contains an 'arbitrary restriction' to achieve it.⁶

2.46 The reasons for the present requirement of IAS 19 to give a net presentation in some circumstances where the employer has a direct obligation to pay benefits do not seem to be convincing and should be reconsidered. A gross presentation would appropriately reflect the economic substance and be consistent with accounting principles that are applied elsewhere.

3 The employer's consolidated financial statements

3.1 In this section, we continue the analysis above and seek to consider whether the requirements of existing financial reporting standards that effectively provide an exemption from reporting pension plans on a consolidated basis remain appropriate. At present existing financial reporting standards permit the assets and liabilities of pension plans to be reported on a 'net basis' rather than require consolidation of the pension plan. To consider whether this remains appropriate we might start by considering whether consolidation of pension plans would improve the information provided to users of financial statements – that is whether consolidation matters.

3.2 It will also be necessary to consider the basis for determining whether the pension plan forms part of the consolidated group. To do this we will consider the IASB's proposals regarding consolidation in contrast to current financial reporting standards for consolidation and assess whether these proposals can be applied to pension plans.

Does consolidation matter?

Objective of consolidated financial statements

3.3 We might start by reviewing the objective of consolidated financial statements. IAS 27 'Consolidated and Separate Financial Statements' does not state the purpose of consolidated financial statements. The IASB has, however, tentatively agreed that it would be useful, if as part of its

⁶ IAS 19 Basis for Conclusions 68H-I.

consolidations project⁷, the purpose of the standard was identified. The IASB is considering the following objective:

The objective is for the entity reporting to present information about the assets and liabilities, and the activities related to those assets and liabilities, for which it holds sufficient rights to be able to consume or settle as if they were legally theirs.

3.4 This objective is not dissimilar to the objective set out in the UK's FRS 2 'Subsidiary Undertakings', which states:

The objective of this FRS is to require parent undertakings to provide financial information about the economic activities of their groups by preparing consolidated financial statements. These statements are intended to present financial information about a parent undertaking and its subsidiary undertakings as a single economic entity to show the economic resources controlled by the group, the obligations of the group and the results the group achieves with its resources.

3.5 The above objective suggests that where a parent entity has sufficient rights to be able to consume or deal with the assets and liabilities of an investment as if they were its own then more meaningful information is provided as if the results of the investor and its investments are presented as a single economic entity. That is, consolidated financial statements combine the assets and liabilities of a parent and its investments to present information about a single economic entity.

3.6 **If it is accepted that the objective of consolidated financial statements is to provide more meaningful information then it is necessary to understand why existing financial reporting standards effectively provide an exemption from the consolidation of pension plans (where the plan is considered to be part of the single economic entity).**

Information provided from consolidated financial statements

3.7 In determining why pension plans are effectively exempt from the requirements of consolidation it is necessary to consider whether there is a particular reason for the exemption. One reason may be that consolidation of pension plans does not provide meaningful information.

3.8 The question of whether financial statements should consolidate pension plans is not discussed in either IAS 19 'Employee Benefits' or SFAS 87 'Employers' Accounting for Pensions'. The consolidation of pension plans was however considered in a discussion paper 'Pension Costs in the Employer's Financial Statements' issued by the ASB in 1995. This paper discussed the presentation of a pension plan as a quasi-subsidiary (special purpose entity) and accounting separately for assets and liabilities. The ASB, at that time, did not consider that consolidation of pension plans in the accounts of the employer would provide

⁷ In June 2003 the IASB decided to undertake a project on consolidation based on a definition of control.

more relevant information than 'net' presentation. This decision was, in part, related to the UK position where pension plan financial statements are essentially a statement of assets and accrued expenses and so consolidating the financial statements of the plan would not bring a liability for accrued pension onto the balance sheet of the employing entity. The ASB therefore considered more relevant information was provided by incorporating the net asset or liability in the employer's financial statements with supplementary disclosures to the components of this net amount.

3.9 The ASB also considered accounting for the separate assets and liabilities of the pension plan in the employer's financial statements. It did not consider such information would provide useful information, but noted that the pension assets and liabilities of some schemes would overshadow, or even completely swamp, most amounts already reported in the balance sheet.

3.10 This view was unchanged in the final standard, FRS 17 'Retirement Benefits': which was issued in November 2000. The following is an extract from the 'Development of the Standard':

Pension schemes will not usually be subsidiary (or quasi-sub subsidiary) undertakings of the employer because defined benefit schemes are controlled by the trustees, not the employer. It is not, therefore, appropriate to consolidate the scheme into the employer's financial statements. A pension scheme can give rise to assets and liabilities of the employer but these are not the gross amounts of the pension scheme assets and liabilities – the employer does not control the assets nor is it directly liable for the pension payments. Instead, the employer has a pension asset or liability to the extent that it is entitled to benefit from any surplus or has a legal or constructive obligation to make good any deficit.

3.11 More recently, however, the SEC in its report into off-balance sheet arrangements⁸ discussed consolidation and noted:

... many U.S. companies choose to fund their pension arrangements by setting up separate entities for their pension plans and funding those plans. Although companies generally have almost the same risks and rewards and much of the same level of control over the assets and obligations whether they are in a separate plan or not, the accounting changes completely if a plan is used.

3.12 It is also noted in the SEC report that:

Consolidation— Given the fact that the plan sponsor generally controls and is subject to the vast majority of the risks and rewards of the pension plan, there is not an obvious conceptual reason why the plan should not be consolidated, especially since other trusts used to fund liabilities typically are consolidated. In addition, the consolidation exemption results in a very different financial statement presentation based on whether a separate entity is used to manage the retirement benefits. While separate plans are common in the U.S.

⁸ Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers; issued June 2005

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because of employment and tax laws, laws in other jurisdictions vary, again raising the possibility of different accounting for similar transactions.

3.13 The SEC argument suggests that the reason why pension plans are not included in consolidated financial statements should be reconsidered. In addition the arguments previously presented by the ASB assume that all pension plans are controlled by the trustees; whilst legislation in some jurisdictions compels pension plan trustees to act independently from the employing entity this view may not be correct in all.

Does consolidation improve the quality of information?

3.14 In July 2006 the IASB published a discussion paper 'Preliminary Views on an improved Conceptual Framework for Financial Reporting'. In this discussion paper it is noted that the objective of general purpose financial statements is to provide information that is useful to present and potential investors and creditors and others in making investment, credit and similar resource allocation decisions.

3.15 To consider whether the consolidation of pension plans would provide more useful information to the users of financial statements we need to consider the difference between information that is currently presented regarding pension plans and information which might be presented were a pension plan consolidated as part of group financial statements.

3.16 At present financial reporting standards permit a single amount to be recognised in the balance sheet of the reporting entity for pension plans. The liabilities of the plan are offset against the assets held to fund pension liabilities (net presentation). The costs of providing pension benefits are reported in profit and loss either as a single line item or within individual line items to which they relate.

3.17 Under existing financial reporting standards the assets of the pension plan are deducted from the liabilities and more detailed disclosures regarding the assets and liabilities of the plan are provided in the notes to the financial statements. A user can clearly identify assets that are segregated to fund pension benefits. Were the financial statements of the pension plan consolidated as part of the group financial statements then the assets of the plan (normally financial assets) would be combined with other financial assets of the employing entity.

3.18 If pension plans were consolidated then the financial statements of the employing entity would combine the assets and liabilities of the pension plan with those of its own. The most noticeable change this would bring would be to the balance sheet where the assets and liabilities of the plan would be presented within the balance sheet category to which they relate – that is they would be presented gross (gross presentation).

3.19 We need to consider whether gross presentation improves the quality of information for the user of financial statements. One view is that combining the assets held to fund pension benefits with other financial assets reduces the information a user has available as it is no longer possible for a user to

distinguish assets held to fund pension benefits from other assets. In these circumstances it will be necessary to consider whether additional disclosures are required concerning assets held to fund pension benefits or whether assets held to fund pension benefits should be identified as a separate class of assets.

3.20 An alternative view, however, is that if the reporting entity has similar rights over the assets held to fund pension benefits to other assets there is little, if any, justification that the assets held to fund pension benefits warrant a different presentation to assets that are held for other purposes. That is, gross presentation presents the total economic resources available to the entity.

3.21 Thus a case can be made that more useful information is provided, where the employing entity has control of the pension plan, if the assets and liabilities of the plan are presented 'gross'. That is 'gross' presentation provides greater information about the resources an entity controls. However, supplementary disclosures may be necessary of assets held to fund pension benefits and the pension liability.

3.22 The consolidation of pension plans needs to be considered in the context of useful information being provided to users of financial statements. Where a pension plan is part of the single economic entity (the group) then the above analysis suggests that the usefulness of information is improved if the pension plan is consolidated (where the plan forms part of the single economic entity).

The IASB's consolidation project

3.23 In deciding which entities form the single economic entity (the group) a unifying factor is required. IAS 27 states that consolidated financial statements shall include all subsidiaries of the parent. A subsidiary is defined as an entity, including an unincorporated entity such as a partnership that is controlled by another entity (known as a parent).

3.24 It is noted in IAS 27 that control exists, in addition to voting interests, when the parent owns half or less of the voting powers of an entity when there is:

- (a) power over more than half of the voting rights by virtue of an agreement with other investors;
- (b) power to govern the financial and operating policies of the entity under a statute or an agreement;
- (c) power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or
- (d) power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.

3.25 IAS 27 therefore uses control as a unifying factor. Control is determined by the power to govern the financial and operating policies of another entity so as to obtain benefits from its activities. This

definition of control has two elements: power (ability to govern the financial and operating policies of another entity) and benefit (to obtain benefit from its activities).

3.26 The IASB has, however, been reconsidering IAS 27 as part of its consolidations project. The project includes considering whether effective control rather than legal control is a sufficient basis for consolidation. This paper utilises the preliminary findings and tentative decisions reached by the IASB in its consolidation project as at 30 November 2007.

Analysis of IASB consolidation project – tentative decisions

3.27 The objective of the IASB's consolidations project is to identify the criteria for when an investor is required to include the assets, liabilities and activities of its investments in its consolidated financial statements. In July 2006 the IASB reconsidered its earlier definition of control and tentatively agreed that a parent entity has a controlling interest in another entity:

... when it has exclusive rights over that entity's assets and liabilities which give it access to the benefit of those assets and liabilities and the ability to increase, maintain or protect the amount of those benefits.

Therefore, to control an entity the potential controller must satisfy three tests:

- (a) *it must have the ability to direct the strategic planning and operating policies of the entity (the 'Power Criterion');*
- (b) *it must have the ability to access the benefits flowing from the entity (the 'Benefits Criterion');* and
- (c) *it must be able to use its Power so as to increase, maintain or protect the amount of those benefits.*

3.28 The IASB is considering this approach (rather than an earlier approach that focused on control being the ability of the reporting entity to direct the strategic financing and operating policies of an entity so as to access the benefits flowing from the entity and increase maintain or protect the amount of those benefits) as it is envisaged that this change in focus will assist in the consolidation issues that surround special purpose entities. In addition it is also considered that the change is appropriate because use of assets and liabilities of the entity is, ultimately, what power over the strategic financing and operating policies is intended to capture.

3.29 The criteria for consolidation, using the IASB's tentative decision, seems likely to focus on whether an entity has rights and responsibilities over another entity's assets and liabilities which give it access to the benefits of those assets and liabilities and the ability to increase, maintain or protect the amount of those benefits as if they were its own.

3.30 As part of the consolidation project the IASB has identified that its proposals build on two very important presumptions, which have their roots in basic finance theory and economic property rights theory, these are:

- the relationship between risk and rewards; and
- the relationship between rights and benefits.

3.31 The foundations of the project presume that an entity that absorbs the variability of an asset is the party that benefits from the asset. The term variability is used in relation to who bears the risks or receives the rewards. It follows that the more variability a party is expected to absorb the more control the party will want to have over the assets causing the variability.

3.32 To determine whether an entity forms part of the single entity (the group) the IASB's proposals suggest identifying what rights each party has (and the variability they are absorbing) in order to determine who controls the entity.

3.33 Under the traditional control model, the benefits realised by an investor are generally proportionate to the power held. In these instances it is not normally difficult to determine who has control; however this may not always hold true. That is to say the entity holding the majority of the voting rights in some arrangements might not control the entity particularly if the operating and financial policies have been predetermined. These arrangements are sometimes referred to as Special Purpose Entities (SPE or quasi-subidiaries). Current requirements for SPEs in IFRS and US GAAP are reviewed in an Appendix to this Chapter.

3.34 In view of the fact that the IASB's consolidation project aims to replace IAS 27 and SIC 12 it seems sensible to apply the IASB's latest thinking from its consolidation project as to whether pension plans form part of the consolidated group. The IASB's working definition⁹ of when a parent entity controls another is:

An entity has a controlling interest in another entity when it has the exclusive rights over that entity's assets and liabilities which give it access to the benefits of those assets and liabilities and the ability to increase, maintain and protect the amount of those benefits

3.35 To establish whether an entity controls a pension plan it is necessary to consider how the assets and liabilities of the plan are controlled and whether these control mechanisms provide evidence (that is indicators of control) about who has control of the pension plan.

The role of pension plans

3.36 In determining whether a pension plan meets the criteria for consolidation the nature and role of the pension plan needs to be examined.

⁹ see paragraph 3.29.

3.37 The following section is based, primarily, on the common position where pension plans are established as trusts. The two main reasons for pension plans being established as trusts are:

- it separates the pension plan's assets from those of the employer. This is important as it provides security to the employers pension promise; and
- it is often tax efficient to establish a pension trust.

3.38 Trust law has developed over many years. The basis of trust law is that one group of people (the trustees) hold assets for the benefit of another group of people (the beneficiaries).

3.39 Plans are generally governed by a trust deed and/or in addition (or combined with the trust deed) are the scheme rules. Traditionally the responsibilities of trustees are divided into three categories; duties, powers and discretionary powers. Duties are tasks which the trustees must ensure are carried out. Powers are rights which the trust deed and rules give to trustees. Discretionary powers are powers given by the trust deed to the trustees which permit choice, with the best interest of the beneficiaries in mind.

3.40 In undertaking his/her responsibilities a trustee must act in the best interests of the trust beneficiaries. A beneficiary is anyone who is entitled to, or who might receive, benefit from the trust now or in the future.

3.41 In executing his duties a trustee must act within the framework of the law. There are several types of law that affect occupational pension schemes, including:

- the general law of trusts; and
- specific law applying to pension schemes.

3.42 The trustees must act within their powers to protect scheme beneficiaries. Powers to this end are likely to include:

- accepting contributions;
- deciding on the investment strategy; and
- agreeing contribution and funding principles with the sponsoring employer.

3.43 There is a natural tension between the trustees of the pension plan and the employing entity. In exercising powers to protect the position of beneficiaries, trustees need to take into consideration the position of the employing entity. This will often mean balancing the employer's position with that of the plan's beneficiaries. This is a particular issue when agreeing funding levels with the employing entity, it is important to the beneficiaries that the employing entity remains financially healthy.

3.44 The relationship between the employing entity and the trustees, particularly the power of trustees, will be fundamental in establishing whether a reporting entity controls the pension plan.

3.45 Our understanding is that, internationally, in most countries the boards of pension plans are comprised of representatives of both employers and members. Furthermore, in most countries managers of pension plans are required to have regard to the members' interests, sometimes jointly with employers' interests.

Application of the notion of 'control' to the consolidation of pension plans

3.46 The areas of a pension plan that are significant and might be considered to provide evidence as to where control vests are thought to include:

constitution of pension plan board (including the appointment, duties and responsibilities of the managers/(trustees));

- (i) who has access to the pension plan;
- (ii) who benefits from the plan; and
- (iii) who determines the investment and funding policy.

(i) Constitution of the pension plan board

3.47 The role of the trustees is discussed above under the title 'the role of pension plans'. This identified that trustees are required to act in the best interest of the plan's beneficiaries. In acting in the beneficiaries' interest they must balance the beneficiaries' position with that of the employing entity. The evidence collated during the development of this discussion paper suggests managers/(trustees) in many jurisdictions act in the interest of both the plan beneficiaries and the employer.

3.48 Some may therefore argue that an employing entity can obtain control of the pension plan by appointing managers/(trustees) to the pension plan board that empathise with its position and as a result can affect the decisions made by the pension plan managers/(trustees). The appointment of managers/(trustees) and constitution of the trustee board is, however, regulated through the trust deed and scheme rules and in addition supplemented by law.

3.49 Appointment alone, however, may not determine control of the plan, for example, once the trustees of a pension plan are appointed in the UK, they are required to act for the benefit of the plan's beneficiaries who are principally present and past employees and families/dependents rather than the employing entity. In these circumstances even if an employer were able to select and appoint managers/(trustees) that empathised with its position, once appointed the manager/(trustee) will not be able to act other than in the interests of the plan's beneficiaries. In addition, once appointed, employer

nominated trustees must in the case of any conflict of interest carry out their duties as trustees in preference to the interests of the employing entity. A trustee not acting in the interest of the beneficiaries risks being held in breach of trust.

3.50 The role of managers/ (trustees) is influenced by the powers and duties vested in them in accordance with the trust deed and by Regulation. The UK Pension Regulator, for example, has issued a code of practice for UK trustees of pension plans. The purpose of this code is to provide practical guidelines on what knowledge and understanding is required by trustees under the legislation, and to set out the scheme documents with which trustees are required to be conversant with.

3.51 In view of the regulation surrounding the role of pension plan managers/(trustees) where a plan is established it will be necessary to determine if control of the plan is vested in the management (board) of the plan or whether the employer has control of the plan - that is whether the employer can affect the decisions reached by managers/(trustees) of the plan. This will require, in addition to judgement being exercised, the regulatory framework in which the plan operates to be considered. It might be concluded that local laws and/or regulation stipulate how managers/(trustees) are appointed and prohibit trustees from acting other than for the benefit of scheme beneficiaries. In applying judgement it will be necessary to consider the substance of the relationship between the reporting entity and the pension plan.

3.52 In determining who has control of the pension plan it is necessary to establish whether the reporting entity has the decision making powers of the pension plan and can direct managers/(trustees). This will require consideration of all relevant factors, including regulatory influences, and be based on the substance of the relationship between the employer and the pension plan.

(ii) *Who has access to the pension plan*

3.53 In considering whether access to the pension plan provides an indicator of control it might be helpful to consider the position of the employer and of the employee:

- *the employer* in exchange for the employee services, permits an employee to participate in a pension plan which he sponsors. The employer obtains benefits from the provision of employee services of which part of the settlement for those services is deferred as a future pension payment.
- *the employee* as a beneficiary of the plan expects a pension payment for employment services provided in the past. The amount of pension however depends on terms agreed by the employer.

3.54 We might also consider the role of the managers/(trustees) of a pension plan. Managers/(trustees) normally have only limited ability to affect the level of benefit offered to employees by the employer – their role is principally to secure the payment to the beneficiaries. Arguably the liabilities of the scheme are “handed down” to the pension plan by the employing entity and the managers/(trustees) role is to protect the pension promise by securing funding by contributions from the employer and ensuring an

effective investment policy. It therefore seems unlikely trustees can affect the liability, although they may be able to affect the amount required by the employer to settle this liability through investment policy decisions.

3.55 The above suggests that managers/(trustees) are not party to the offer of benefits and have limited ability to control pension liabilities. However, the plan's constitution (e.g. trust deed) may provide the managers/ (trustees) with certain powers to protect benefits already earned and/or to protect future benefits for existing beneficiaries (i.e. the ability to restrict an employer from altering the level of future benefits). In these circumstances certain elements of control, regarding benefits, have arguably been passed to the managers/(trustees) of the plan.

3.56 In determining whether an employing entity has control of a pension plan it is necessary to determine whether the offer of benefits is an indicator of control to the plan itself. The analysis set out above suggests that the employer makes the offer of benefits and accepts the variability associated with the offer. Managers/ (trustees) are not normally party to the offer of benefits; however, a trustee may have a role in the protection of benefits depending on the constitution of the plan (i.e. through the trust deed). It would seem an employer controls the offer of benefits and receives in exchange for that offer employee services. The employer accepts variability associated with the deferred settlement of the liability that arises in exchange for services.

3.57 It follows from the foregoing that who has access to the plan is not normally an indicator of control of a pension plan; normally an employer controls access to the plan.

(iii) *Who benefits from the pension plan?*

3.58 As with above it might be useful to consider the employer and employee separately.

3.59 *The employee*, in exchange for services, obtains a remuneration of which some is deferred. The deferral is sometimes protected by an intermediate entity - the pension plan. The employee as a beneficiary of the plan expects a pension payment for employment services provided in the past. The amount of pension however depends on terms agreed by the employer. This would suggest it is the employee who benefits from the plan.

3.60 *The employer*, having made the offer and accepted the employees' services has a liability in respect of accrued benefits and assumes the variability associated with settlement of this liability. The benefits the employer receives arise from the contract of employment (that is the delivery of service by the employee) rather than the pension plan itself. The employer may receive some benefits from sponsorship of the plan, such as the ability to attract and retain staff, but these are of an intangible nature.

3.61 In certain circumstances (for instance where employers and employees share surpluses) the employer will also be a beneficiary to the pension plan. The question therefore arises as to whether the access to participate in surplus provides evidence as to the control of the pension plan.

3.62 We have previously noted the role of the pension plan is to separate the pension plan's assets from those of the employer, providing security to the employer's pension promise. The managers/(trustees) of the plan aim to protect these benefits through funding and investment strategies. This is an important distinction – in so much as the role of managers/(trustees) is not normally to maximise the return on assets to the pension fund but to secure and protect benefits for the plan's beneficiaries. This would suggest that a surplus is a "by-product" of the plan's principal role and therefore where the employer benefits in this manner it cannot provide evidence as to the control of the plan itself.

3.63 The analysis above suggests the employer does not benefit from pension plan itself but accepts the variability associated with settlement of liabilities that arise from the contract of employment. The variability is both upside (i.e. through reduced contributions or the ability to participate in a surplus) or downside risk where increased funding is requested. The downside risk can be demonstrated in relation to longevity risk which is a significant factor contributing to increasing the cost of pensions and is a clear risk that employers have assumed.

3.64 To determine control of an entity the IASB, as part of its consolidation project, plans to assume that the entity that absorbs the variability of the asset is the party that benefits from the asset. The analysis above does not contradict this argument because the employer makes the offer of pension benefits in consideration for the employee providing services (and thereby obtains benefits from employee service). The employer having obtained benefits through the employment contract accepts the variability (risk) associated with settlement of this liability.

3.65 In determining who has control of the pension plan; the identity of the party that benefits from the plan will not normally be an indicator of control because by definition the role of the plan is to secure benefits to beneficiaries not to maximise returns to the employer.

(iv) Investment and funding policy

3.66 Where the role of the plan is to protect the beneficiaries of the plan, managers/(trustees) will aim to protect the beneficiaries of the pension plan by ensuring the plan is adequately funded (funding policy) and through the returns on the assets that are held by the plan (investment policy).

3.67 The funding and investment decisions that the trustees are able to make have consequences on the employer, i.e. the funding requirements of the scheme affect the economic resources that are available to the entity. The investment decisions have an affect on the amount of funding that will be required by the employer to fulfil its pension obligations.

3.68 In some arrangements the benefit to the employee is linked to the return on assets; in these circumstances the employer may guarantee a return to beneficiaries of the plan. This raises a question regarding who benefits from the assets of the plan. As noted above the investment decisions affect the funding requirements from the employer – good performance will reduce the amount of funding

required. In which case, it may be argued that the employer benefits from the return on assets. However, we have also noted that separating the assets to fund pension benefits from the employer provides security to the employers pension promise and thereby the return on assets benefits scheme beneficiaries.

3.69 In determining who has control of the pension plan a critical consideration is which party has the ability to set the investment and funding policies of the plan.

Conclusions on control

3.70 In this section we have sought to identify if the IASB latest thinking arising from its consolidation project can be applied to pension plans. A reporting entity will have control of a pension plan where it meets the IASB's working definition of control, that is:

When it has the exclusive rights over the plan's assets and liabilities which give it access to the benefits of those assets and liabilities and the ability to increase, maintain and protect the amount of those benefits.

3.71 In evaluating whether a pension plan forms part of the consolidated group we have identified indicators that provide evidence an entity has control of the pension plan. These include:

(a) where the employer has the decision making powers of the plan and can direct managers/(trustees) of the pension plan. This will require consideration of all relevant factors, including regulatory influences, and be based on the substance of the relationship between the employer and the pension plan. Indicators that an employer has the decision making powers of the plan might include:

where the employer can appoint and remove the majority of managers/(trustees) at its discretion; and

whether once appointed, managers/(trustees) can act on behalf of the employer (i.e. the employer can direct the actions of managers/(trustees));

and/or

(b) where the employer can determine the investment and funding policies of the plan and can offer and/or change benefits without the need to consult the managers/(trustees) of the plan.

An indicator that an employer does not have control of the plan is the effect of regulation, especially where regulation determines appointment of trustees and how trustees should act when performing their duties and therefore restricts the employer's ability to "influence" trustees.

Summary of views on consolidation

3.72 In this Chapter we sought to answer the question – should pension plans be consolidated in the financial statements of the employer. The analysis in this Chapter suggests there is no conceptual reason why existing financial reporting standards provide an exemption from the consolidation of pension plans.

3.73 The notion of control (that is whether the consolidated financial statements should include those entities the parent entity has rights over that entity's assets and liabilities which give it access to the benefit of those assets and liabilities and the ability to increase, maintain or protect the amount of those benefits) provides a suitable means to determine whether a plan should be consolidated.

3.74 The analysis has led to the development of indicators to determine whether the employing entity has control of the pension plan. The use of these indicators should assist in determining if the employing entity has control of the pension plan – in which instance consolidation would be required. Alternatively the use of the indicators may determine the employing entity does not have control – that is control of the plan is with another or held by the managers/(trustees) of the plan itself.

3.75 The application of the notion of control would result in some pension plans (those that are controlled by the reporting entity) being consolidated into the group financial statements – whereas other plans an entity participates in would not be consolidated. It might be argued that it gives rise to a level of inconsistency in financial reporting that is not helpful. However, if the criteria for consolidation were founded on appropriate economic principles, then all plans in similar economic relationships with employers would be either consolidated or not consolidated as appropriate.

3.76 Where it is determined that an entity does have control of the plan then consolidation of the plan will result in the assets and liabilities of the plan being presented “gross” in the employer's consolidated financial statements.

4 Summary

4.1 This Chapter considers how obligations to provide pension benefits and assets held to pay such benefits should be reflected in the financial statements of an employer and of a pension plan. It considers an employer's individual and consolidated financial statements.

Individual financial statements

4.2 If the employing entity is directly responsible for paying the benefits promised to employees, the liability must rest directly with the employing entity. (Paragraphs 2.4-2.6)

4.3 Where a pension is provided by a third party (such as insurance company) some or all of the employer's present obligation to the employee is extinguished by transferring assets (i.e. paying agreed contributions) to that third party. (Paragraphs 2.7-2.18)

4.4 Where a fund of assets is established which is not transferred to a separate entity (i.e. it is simply a collection of assets of the employing entity):

- the assets held in the fund are reported as assets of the employing entity in its individual financial statements; and
- the obligation to pay benefits is a liability of the employing entity (i.e. it is not a liability of any other reporting entity).

(Paragraphs 2.23-2.27)

4.5 Where assets are transferred from the employer to an employer-sponsored plan:

- If the employer has the legal or constructive obligation to pay benefits, it will have a liability to pay benefits and also an asset, representing its right to reimbursement from the plan. (Paragraphs 2.34-2.38)
- If the plan assumes the obligation to pay benefits and the employer has an obligation to make contributions to the plan to the extent that the plan's obligations cannot be met from its own assets, the asset or liability that is properly representative of the employer's rights and obligations is a net asset or liability that reflects its right to benefit from a surplus or its obligation to contribute to a deficit. (Paragraphs 2.39-2.42)

4.6 The reasons for the present requirement of IAS 19 to give a net presentation in some circumstances where the employer has a direct obligation to pay benefits do not seem to be convincing and should be reconsidered. A gross presentation would appropriately reflect the economic substance and be consistent with accounting principles that are applied elsewhere. (Paragraphs 2.43-2.46)

The employer's consolidated financial statements

4.7 There is no conceptual reason why financial reporting standards should provide an exemption from the consolidation of pension plans. Where a pension plan is part of a single economic entity (the group) then the usefulness of the information in the employer's financial statements is improved if the pension plan is consolidated. (Paragraphs 3.3-3.22)

4.8 Where it is determined that an entity does have control of the plan then consolidation of the plan will result in the assets and liabilities of the plan being presented "gross" in the employer's consolidated financial statements. (Paragraphs 3.14-3.22)

4.9 The notion of control (based on whether the employer has rights over the plan's assets and liabilities which give it access to the benefit of those assets and liabilities and the ability to increase, maintain or protect the amount of those benefits) provides a suitable means to determine whether a plan should be consolidated. (Paragraphs 3.23-3.35)

The financial reporting of pensions

4.10 Control may arise where the employer has the decision making powers of the plan and can direct managers/(trustees) of the pension plan or can determine investment, funding or benefit policy. Determination of this will require consideration of all relevant factors, including regulatory influences, and be based on the substance of the relationship between the employer and the pension plan. (Paragraphs 3.36-3.71)

4.11 The application of the notion of control would result in some pension plans being consolidated into the group financial statements – whereas other plans in which an entity participates might not be consolidated. It might be argued that this gives rise to inconsistency. However, if the criteria for consolidation are founded on appropriate principles, then the accounting treatment would reflect the economic substance of the relationship between the entity and all its plans. (Paragraph 3.75)

APPENDIX A

Special purpose entities

A.1 Where the “traditional control” model does not hold true it is necessary to consider alternative approaches to consolidation. Entities that do not conform to the “traditional control” model approach are sometimes referred to as special purpose entities (SPEs).

A.2 IFRSs do not contain a definition of SPEs but SIC 12 ‘Consolidation – Special Purpose Entities’ addresses the circumstances in which an entity should consolidate a SPE. SIC 12 is consistent with IAS 27 in that it uses control as a unifying factor for consolidation. However, SIC 12 is applied when it is not possible, applying the normal provisions of IAS 27, to determine who has control. SIC 12 requires consolidation where the substance of the relationship between an entity and a SPE indicates the entity has control of the SPE. To determine whether the SPE is controlled by that entity judgement is required by considering relevant factors. In addition SIC 12 provides some indicators of control, these include:

- (a) where in substance, the activities of the SPE are being conducted on behalf of the entity according to its specific business needs so that the entity obtains benefits;
- (b) in substance, the entity has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an ‘autopilot’ mechanism, the entity has delegated these decision-making powers;
- (c) in substance, the entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risk incident to the activities of the SPE; or
- (d) in substance, the entity retains the majority of the residual or ownership risks related to the SPE of its assets in order to obtain benefits from its activities.

A.3 The first indicator above focuses on benefits and is similar to FRS 5 ‘Reporting the substance of Transactions’ which states:

Where the financial and operating policies of a vehicle are in substance pre-determined, contractually or otherwise, the party possessing control will be the one that gains benefits arising from the net assets of the vehicle. Evidence of which party gains these benefits is given by which party is exposed to the risk inherent in them.

A.4 The second indicator is about decision making powers so as to control the SPE and discusses autopilots. Some hold the view that pension plans fall within the category of autopilots. Those that hold this view consider that pension plans are established for a specified purpose and that the duties and responsibilities of trustees were defined (and thereby limited) in the trust deed. They consider that an entity has the decision making powers and obtains the benefits from the provision of services under the

contract for employment – pensions are merely deferred remuneration.

A.5 The third and fourth indicators are about risk – in these circumstances an SPE is likely to be a subsidiary where the originator (parent) retains the majority of the residual or ownership risks. This may be determined by evaluating the risks of each party engaging in transactions with the SPE.

A.6 An alternative approach to SIC 12 is used in US GAAP FIN 46(R) 'Consolidation of Variable-Interest Entities' (VIE). Under FIN 46(R) an entity is required to consolidate a VIE if the entity has a variable interest (or a combination of variable interests) that will absorb a majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both. 'Variable interests' in a VIE are contractual, ownership or other pecuniary interests in an entity that change with changes in the fair value of the entity's net assets exclusive of variable interests. An enterprise that consolidates a VIE is called the primary beneficiary.

A.7 The IASB is attempting to develop a single control model which can be applied where the traditional control model holds true and also to SPEs. The proposed model will determine control by identifying which entity is exposed to risks and rewards (and therefore absorbs the variability). This model is consistent with the FIN 46 (R) in that it uses variability in an attempt to identify the controller.

A.8 In developing the control model the IASB staff plan to develop indicators that evidence the nature of the relationship between the investor and the investee. Indicators might include:

- the ability to dominate the governing body, and therefore the strategic policy decision process;
- the ability to participate in the management of an entity; or
- the ability to access the residual assets of an entity.

Chapter 4: Recognition of pension assets and liabilities

1 Introduction

1.1 Previous Chapters of this discussion paper have considered how the liabilities to pay pension benefits and the assets that are held to fund those benefits might be defined. The next step is to consider the recognition of these assets and liabilities.

1.2 There has historically been much debate concerning the recognition of assets and liabilities in relation to the provision of pension benefits. For example, the issue by the ASB of FRS 17 'Retirement Benefits' which requires pension assets and liabilities to be recognised immediately and in full was controversial.

1.3 The IASB Framework states that recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition as set out in the Framework. Recognition is therefore distinct from presentation—that is how items that are recognised are portrayed within financial statements. This Chapter is concerned only with recognition: presentation is discussed in Chapter 8.

1.4 The next section of this Chapter discusses what the Framework has to say on recognition in more detail.

2 The IASB Framework and recognition

2.1 The IASB Framework states:

An item that meets the definition of an element should be recognised if:

(a) *it is probable that any future economic benefit associated with the item will flow to or from the entity; and*

(b) *the item has a cost or value that can be measured with reliability.*

2.2 There are two criteria: probability of future economic benefit and reliability of measurement. The Framework explains that the concept of probability is used in the recognition criterion to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the entity. In relation to an obligation to pay pension benefits, there is little uncertainty that future economic benefits will flow from the entity, as there is usually a contractual obligation to make payments. Uncertainty arises only in relation to *how much* will be paid.

2.3 As noted in Chapter 3, an employer or other entity may be liable to reimburse another entity (for example, a pension plan) in some circumstances. In such a case it might be suggested that it is not necessarily probable that any future economic benefit associated with the item will flow to or from the

entity. However, this issue has been considered by IASB in their exposure draft of Amendments to IAS 37¹. There it is noted that an entity that provides a guarantee has an unconditional obligation to honour that guarantee, and that the outflow of economic benefits should be regarded as the provision of services rather than the making of any possible payments (BC42). Where an entity has guaranteed pensions, there is little uncertainty that it will provide services by standing ready to honour the guarantee should it be necessary to do so.

2.4 If this analysis is accepted, both obligations to pay pensions and obligations to reimburse another party fulfil the first part of the recognition criterion in the Framework.

2.5 The amount to be paid is linked to the second element of the criterion; the measurement of liabilities to pay pension benefits and the assets held to fund those benefits. For present purposes it suffices to note that under present practice it is accepted that there are some measurement approaches that are considered sufficiently reliable to permit recognition. Specific proposals for the measurement of these liabilities and assets are discussed in Chapters 5 and 6.

2.6 It can therefore be concluded that assets and liabilities relating to pensions, and changes in those assets and liabilities, meet the criteria for recognition that are given in the Framework. If they are not to be recognised it can be only on pragmatic rather than conceptual grounds.

3 Deferral mechanisms or immediate recognition?

3.1 Current financial reporting standards generally discuss the recognition of actuarial gains and losses (that is, changes in assets and liabilities) rather than that of assets and liabilities relating to pensions. They often require or permit deferral mechanisms to be used for the recognition of such gains and losses.

3.2 One kind of deferral mechanism is to recognise actuarial gains and losses over a future period (for example, the expected future service life of employees) rather than immediately the gains and losses arise. Another kind of deferral mechanism is the 'corridor' approach, under which gains and losses that fall within certain limits may not be recognised at all. Sometimes, as in IAS 19, these approaches are combined.

3.3 The main arguments that are advanced in support of deferral mechanisms are summarised below.

(i) Immediate recognition implies a level of accuracy as to the measurement of liabilities that is not true in practice. Pension obligations cannot be measured reliably due to the uncertainty over the period of time that benefits will be paid and the inherent uncertainties associated with the assumptions used to measure them. Thus, immediate recognition introduces volatility into the financial statements, which often presents a misleading view, as changes frequently represent

¹ 'Exposure Draft of Proposed Amendments to IAS 37, Provisions Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits' June 2005.

changes in the measurement of the obligation rather than an economic event of the period. This is particularly important as relatively small changes in assumptions can lead to very significant changes in the liability.

- (ii) Changes in the value of assets held to fund pension liabilities are not relevant. This is based on the view that asset values are based on current market values which are volatile in the short term. However, as the assets are held to fund pension liabilities which are settled over the long term, short term volatility is irrelevant. In view of the long term nature of pension arrangements, the gains and losses due to market fluctuations can be expected to reverse.
- (iii) Requiring immediate recognition of changes in the value of assets and liabilities may cause entities to make decisions about the provision of pension benefits that may not be economically effective.

3.4 These arguments are countered by those who oppose deferral mechanisms (and thus support immediate recognition) as follows.

- (i) There are many items in financial statements that are difficult to measure and have inherent uncertainties. Changes in assets and liabilities are usually recognised immediately and in full. There seems no justification for treating liabilities for pensions differently from other items in financial statements.
- (ii) There is little basis for the suggestion that changes in market values will necessarily reverse over time – future offset of past losses and gains is not inevitable. It seems difficult to argue that all changes in market values can be ignored indefinitely, and impossible to specify, except arbitrarily, what changes should and should not be reflected. Volatility is a consequence of market behaviour: the financial statements should seek to report the economic events of the period.
- (iii) Linked to the preceding point, it is for management to devise the investment strategy that they consider appropriate, taking into account their view of the most economically effective strategy. The financial statements do not provide a commentary on the strategy – that is usefully provided by management. Instead the financial statements seek to report the economic events of the period and the financial position at the end of it.

3.5 Another argument for immediate recognition is that it provides transparent information. Deferral mechanisms inevitably require complex and arbitrary rules about which gains and losses may be deferred, by what method, and how (if at all) they are to be ultimately recognised. They usually have the consequence that the balance sheet does not faithfully reflect the position of the pension plan, and so require that this important information is relegated to the notes of the financial statements.

4 The standard-setters' views

4.1 Despite the prevalence in current accounting standards of deferral mechanisms, standard-setters have been unenthusiastic about them for some time.

4.2 For example, when the IASC approved a new version of IAS 19 in 1998, which retained deferral approaches, it noted:

...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 in a statement of financial performance. (IAS 19, Basis for Conclusions, paragraph 2)

4.3 In December 2004, the IASB issued an amendment to IAS 19 which introduced a new option to recognise actuarial gains and losses immediately, outside of profit or loss in a statement of recognized income and expense. At that time the IASB observed:

The argument for immediate recognition of actuarial gains and losses is that they are economic events of the period. Recognising them when they occur provides a faithful representation of those events. It also results in a faithful representation of the plan in the balance sheet. In contrast, when recognition is deferred, the information provided is partial and potentially misleading. Furthermore, any net cumulative deferred actuarial losses can give rise to a debit item in the balance sheet that does not meet the definition of an asset. Similarly, any net cumulative actuarial gains can give rise to a credit item in the balance sheet that does not meet the definition of a liability. (Paragraph BC 48B)

4.4 In the Summary of SFAS 158² the FASB set out its reasons for issuing the statement. It noted:

The Board issued this Statement to address concerns that prior standards on employers' accounting for defined benefit postretirement plans failed to communicate the funded status of those plans in a complete and understandable way. Prior standards did not require an employer to report in its statement of financial position the overfunded or underfunded status of a defined benefit postretirement plan. Those standards did not require an employer to recognize completely in earnings or other comprehensive income the financial effects of certain events affecting the plan's funded status when those events occurred.

Prior accounting standards allowed an employer to recognize in its statement of financial position an asset or liability arising from a defined benefit postretirement plan, which almost always differed from the plan's overfunded or underfunded status. Those standards allowed an employer to:

- a. Delay recognition of economic events that affected the costs of providing postretirement benefits — changes in plan assets and benefit obligations — and recognize a liability that was sometimes significantly less than the underfunded status of the plan.*

² 'Statement of Financial Accounting Standards No. 158: Employers' Accounting for Defined benefit Pension and Other Postretirement Plans', September 2006.

- b. *Recognize an asset in its statement of financial position, in some situations, for a plan that was underfunded.*

Prior standards relegated information about the overfunded or underfunded status of a plan to the notes to financial statements. That information was in the form of a reconciliation of the overfunded or underfunded status to amounts recognized in an employer's statement of financial position. The Board was told that presenting such information only in the notes made it more difficult for users of financial statements to assess an employer's financial position and ability to satisfy postretirement benefit obligations.

The Board concluded that such reporting, together with other features of the existing standards, did not provide representationally faithful and understandable financial information and might lead to the inefficient allocation of resources in the capital markets.

4.5 The IASB, as part of its short-term review of accounting for post employment benefits, has started to reconsider the recognition of gains and losses. One of its tentative decisions is that all changes in a post-employment defined benefit obligation and in the value of plan assets should be recognised in comprehensive income in the period in which they are incurred. This includes all actuarial gains and losses, subject to finding an acceptable approach to presentation. (IASB Project Update: Latest revision September 2007).

5 Conclusions

5.1 The preceding sections of this Chapter have summarised the main arguments as to whether an accounting standard for pensions should require (or permit) deferral mechanisms, or whether it should require immediate recognition. The following points seem to be particularly persuasive.

- (a) Assets and liabilities relating to pensions meet the criteria for the recognition of assets and liabilities, as set out in the IASB's Framework.
- (b) Deferral mechanisms require arbitrary rules to be developed and do not provide transparent information.
- (c) The recognition of assets and liabilities that are representative of an entity's rights and obligations provides a transparent statement of the position of the pension plan

It is also clear that immediate recognition is the direction of travel that standard-setters, including the IASB and the FASB are taking.

5.2 **It is concluded that the arguments that support deferral mechanisms do not provide sufficient justification for the balance sheet to portray assets and liabilities relating to pension plans and changes in them in a manner that is not representationally faithful. Accordingly, accounting standards should not permit these approaches, and all changes should be recognised immediately.**

6 Summary

6.1 Under current standards, changes in the measurement of assets and liabilities relating to pension plans may be deferred, that is recognised prospectively over a period, such as the average remaining service lives of employees. Or a 'corridor' approach may be used, under which changes are not recognised at all unless they exceed a certain threshold.

6.2 Having considered the arguments that support these approaches, the paper concludes that they do not provide sufficient justification for the balance sheet to portray assets and liabilities relating to pensions plans in a manner that is not representationally faithful. Accordingly, accounting standards should not permit these approaches, and all changes should be recognised immediately.

Chapter 5: Measurement of liabilities to pay benefits

1 Introduction

1.1 This Chapter sets out views on the measurement of pension obligations in employers' financial statements (measurement in pension plan's financial statements is considered in Chapter 11).

1.2 Liabilities to pay benefits are incurred in exchange for services rendered by employees. An accounting objective is to measure that exchange, i.e. to record a value for the services received (reported as an expense) and the liability incurred, and to record a value for the liability at each reporting date until it is settled.

1.3 One of the shortcomings of the existing accounting standards on pensions is that they do not state a measurement objective. They specify a measurement method (projected unit method) for defined benefit liabilities – traditionally pension benefits that are related to employees' earnings and length of service. But the measurement requirements of the standards do not deal adequately with the spectrum of risk-sharing that has evolved in pension plans.

1.4 Some believe that pensions do not deserve a unique accounting solution. They see pension obligations as simply one type of debt owed by an entity and in their view the accounting for them should be similar to the accounting for other long-term provisions. The important difference from most other liabilities, which ultimately drives different views, is the complexity of many pension obligations resulting from (a) the length of time between liabilities being incurred and settled and (b) the range of factors that may make the outcome so uncertain.

1.5 In the light of the foregoing, many believe that it would be preferable if:

- a future accounting standard specified a measurement objective (or premise of value), so that the same measurement principles were used for all types of post-employment obligations, and
- those measurement principles were consistent with principles used in other accounting standards for measuring long-term provisions.

1.6 In accordance with the approach outlined in Chapter 1 of this paper, views on the measurement of liabilities have been informed *inter alia* by the objective of financial reporting as set out in the IASB's Framework. Thus it is considered that appropriate measurement principles should be the ones that best help to achieve the objective of providing financial statement users with information about an entity's financial position, performance and changes in financial position that is useful in making economic decisions. Information will help to achieve that objective if it is useful in assessing cash flow prospects, helping users to assess the amounts, timing, and uncertainty of an entity's future cash inflows and outflows.

1.7 This Chapter is structured as follows:

Section 2 – requirements for measurement of liabilities in other accounting literature.

Section 3 – measurements based on current or historical information.

Section 4 – measuring the services received or the liability incurred.

Section 5 – alternative methods of settlement.

Section 6 – current value measures of liabilities.

Section 7 – credit risk of liabilities.

Section 8 – expenses of administering liabilities.

Section 9 - summary

Appendices

A – measurement bases in IASB Framework

B – requirements and proposals for measurement of liabilities under IFRS

C – illustrative example – credit risk

D – Fair Value Discussion Paper

E – IAS 19 BC: discount rate

F – FRS 17, Appendix IV: discount rate

2 Requirements for measuring liabilities in other accounting literature

2.1 As a starting point this section provides an overview of measurement bases set out, firstly, in the IASB Framework and, secondly, in existing accounting standards and current projects to develop new accounting standards.

IASB Framework

2.2 The IASB Framework, in common with the conceptual frameworks of other accounting standard-setters, is under-developed in respect of principles for measurement. Work has commenced at IASB and FASB to develop their conceptual frameworks on measurement.

2.3 Liabilities have several different monetary attributes that could be represented in financial statements. The Framework sets out four different measurement bases for assets and liabilities, without stating any particular preference or stating in which situations a specific measurement basis should be used. These are listed below. A description of the four bases, which are not well developed for liabilities, is given in Appendix A.

Measurement basis	Properties for liabilities
Historical cost	Transaction price
Current cost	Amount of cash that would be required to settle the obligation currently
Realisable (settlement) value	Undiscounted amount of cash expected to be paid to satisfy the liability in the normal course of business (i.e. a <i>future</i> amount)
Present value	Discounted amount of cash expected to be paid to satisfy the liability in the normal course of business (i.e. a <i>current</i> amount)

Accounting standards and current projects on liabilities

2.4 The principal bases used in existing accounting standards and in proposals being developed in current accounting standards projects to measure the types of liabilities that are most relevant to the discussion of pension liabilities are listed in the table below. A fuller description of them is given in Appendix B.

The financial reporting of pensions

Liability	Measurement requirement	Properties
Provisions [IAS 37]	Current settlement amount	<p>Best estimate of expenditure required to settle obligation at balance sheet date</p> <p>Amount that an entity would rationally pay to settle obligation or to transfer it to a third party on balance sheet date [ED of proposed amendments to IAS 37]</p> <p>IAS 37 explains that a provision should be measured at a discounted amount where the effect of the time value of money is material.</p>
Share-based payments [IFRS 2]	Fair value	Amount for which liability could be settled between knowledgeable, willing parties in an arm's length transaction
Financial liabilities [IAS 39]	Amortised historical cost, or Fair value ¹	<p>Carrying value adjusted for cost and income allocations and for changed estimates of cash flows, but not for changes in market rates of interest</p> <p>as above</p>
Insurance contracts [IASB Discussion Paper May 2007]	Current exit value	Reflects current market-based expectations, i.e. assumptions that market participants would use in pricing the liability

¹ The IASB and FASB Boards have stated a long-term objective to require that all financial instruments be measured at fair value.

3 Measurements based on current or historical information

3.1 The first important characteristic that distinguishes the measurement bases listed in Section 2 is whether they are based on current or historical information.²

3.2 Decision-useful information about liabilities should help users to assess the amounts of future cash outflows, their timing and uncertainty. Information about liabilities that are uncertain and of long duration will be more relevant in making that assessment if it provides the most up-to-date information about those uncertainties. In contrast, a measure that reflects historical information about the liability will generally be less useful in helping users assess future cash outflows.

3.3 A current value measure – which reflects the amount of the economic burden of the liability at the measurement date – based on up to date information about present and future economic conditions will therefore rank more highly in terms of decision-usefulness than a measure based on historical cost.

3.4 A current value measure is consistent with the approach taken in other accounting standards in issue (IAS 37, IFRS 2) and in development (revision to IAS 37, insurance) that address liabilities that are uncertain and of long duration.

3.5 When obligations to pay pensions are initially recognised, an accounting objective is to record a value for the services received (reported as an expense) and the liability incurred. The historical cost of many types of pension liabilities will need to be measured initially as a present (discounted) value of the future cash outflows expected in respect of the services received. If the liability were subsequently carried at an amount based on its historical cost (such as in an amortised cost model that is used for certain financial liabilities) different portions of the liabilities that would accumulate over many years would be measured using different discount rates. Over time the amount of the reported liability would not provide any meaningful measure of what is actually owed.

3.6 **For the reasons set out above, this paper concludes that a liability in respect of future pensions should be measured at a current value.**³

4 Measuring the services received or the liability incurred

4.1 One approach to measuring a liability is to measure the amount for which the liability is incurred, which reflects the value of the consideration received in exchange for incurring the obligation. It might therefore also be described as a 'consideration amount'.

² In one case, realisable (settlement) value, the measurement basis is a future amount.

³ The IASB has not yet reached final conclusions on the definition of fair value. It is therefore not possible to compare the current values discussed in this paper with 'fair value'.

4.2 The other approach is to measure the liability directly. This might be described as a 'settlement amount', i.e. it reflects a measure of the cash outflows (or other transfers of economic benefits) needed now or in the future to discharge the liability.

4.3 In the context of benefits for employee services, the measurement method boils down to whether we measure the debit (the value of employee services) or the credit (the liability incurred) side of the transaction. A logical approach would be to measure the side of the transaction that can be most reliably measured.

4.4 Measuring the consideration received may be difficult. Retirement benefits are just one component of an employee's remuneration package and it is doubtful whether it is possible in many cases to (reliably) measure directly the value of services received in exchange for the promise of retirement benefits.⁴

4.5 Even if it were possible to measure directly the value of the services received when the exchange takes place, that would only take care of the initial recognition of the liability incurred in exchange for services rendered. Under a current value approach, an objective is also to record a current value for the liability at each reporting date until it is settled. The idea of remeasuring the liability in subsequent reporting periods by reference to a current value for the services received in exchange for the promise seems very difficult.

4.6 **In the light of the foregoing, it is concluded that a current value measure will be a 'settlement amount', reflecting a measure of the cash outflows (or other transfers of economic benefits) needed now or in the future to discharge the liability.**

5 Alternative methods of settlement

5.1 A pension liability represents a contractual obligation to make a future cash payment or, more usually, a stream of future cash payments.⁵ This section discusses possible alternative methods of settling the liability and how we might choose between them for the purpose of arriving at an accounting measure of the liability.

5.2 The principal ways in which an employer's obligation could be settled are as follows. (By 'settled' we mean the entity is completely absolved from its obligations to its employees and former employees.)

(a) Running off the liability by making payments to the counterparty as they fall due.

⁴ In IFRS 2, the IASB concluded that it is not possible to measure directly the services received, especially services received for individual components of a remuneration package.

⁵ Sometimes a trust or similar entity will have the obligation, and the employer will have an obligation to put the trust in a position so that it can make the future cash payments (see Chapter 3).

In some situations there may be no alternative to achieving settlement by running off the liability by making payments to the counterparty as they fall due; in other words there may be no possibility of settling the liability currently. This might be the case where buy out markets for pensions liabilities are immature and there is insufficient capacity in relation to all the liabilities that exist.

- (b) Immediate buy-out – transferring the liability (or part of the liability) to a third party.

In practice a transfer will usually be to an insurance company or entity of similar credit standing, although it could be to another employer (or another plan).

- (c) Inducing members to accept a reduction in benefits (in full or in part), or a transfer to a different benefit arrangement, in exchange for an immediate cash payment.

To achieve a current settlement of its existing obligations, however, an employer may have to negotiate with employees to change the existing arrangements. This would typically require employees' consent.

Is there more than one settlement amount?

5.3 Consider the simplest case of a retired employee who has the promise of a pension of 10,000 per annum until death. This promise is simply an annuity. Assume that the employer could transfer the liability to an insurance company or it could settle immediately with the pensioner by paying a lump sum.

5.4 It might be suggested that there is no rational reason to conclude that there should be more than one settlement amount:

- If the pensioner is willing to accept a cash settlement, he or she would not rationally be willing to accept a lower price than the employer would have to pay a third party. In other words, the pensioner would want to be compensated to a level at which he or she could purchase an equivalent income stream from a third party.
- There should be no rational reason why the employer would be willing to pay the pensioner more than it would have to pay to transfer the liability to a third party.
- If the employer holds on to the liability and pays the pension itself, the value of its obligation should not be different from the other settlement amounts because the burden of the obligation is currently the same.

5.5 In the real world, however, there may be a host of reasons that could lead to a raft of potential settlement amounts. These include different time preferences and risk appetites. For example, some

pensioners may have a strong personal preference for cash today rather than in the future (perhaps for reasons relating to lifestyle choices, or the pensioner's feeling about his or her own life expectancy), making them susceptible to accept an employer's offer of a cash inducement to extinguish or reduce future benefit payments. The employer is likely to regard such an offer as good value for the obligations from which it would be absolved.

How might we choose between alternative settlement amounts?

5.6 Different economic entities are subject to different constraints and opportunities. Part of the debate about measurement concepts concerns whether and how these differences are reflected in the choice of a measurement basis – for example, does one measure capture all or can different economic positions give rise to different bases.

5.7 In the context of accounting for assets, accounting measurements often reflect that a rational owner of an asset will seek to manage or use the asset to maximise the amount that can be recovered from it (subject to any constraints imposed by, for example, contractual or regulatory arrangements). With exceptions, the present accounting model for measuring impairments of assets⁶ includes a ceiling on the recoverable amount at which an asset is reported in the balance sheet – the higher of the amount that can be recovered through use (described as 'value in use') or sale (described as 'fair value less costs to sell'). An asset's fair value or replacement cost provides an overall ceiling on the asset's carrying amount, i.e. it can never be measured at a higher amount.

5.8 Similarly, when accounting for liabilities it seems reasonable to reflect profit maximising behaviour by a rational holder of a liability; in other words, to assume that it will seek to discharge its obligation by the most economical means available, within the constraints and opportunities that the entity is subject to (including, of course, legal and regulatory constraints).

5.9 Put simply, if the value of the stream of future cash payments from running off a liability was 80, the entity would not rationally pay more than 80 to achieve settlement. So if the entity was also able to achieve immediate settlement by buying out the liability for 100, the liability would be reported at the lower amount.

5.10 That is not to say that the employer should take the least expensive option, or that is acting irrationally if it does not. Other factors might influence the employer's actions, such as its own appetite for bearing risk, its relationships with its employees and so on. If the entity decided to buy out the liability, for example to divest itself of the activity of running a pension plan in order to concentrate on its core business, the loss would be reported in the period in which the liability was bought out. Similarly, in the event (perhaps unlikely) that the entity could achieve settlement by buying out the liability for 70, the liability would be reported at the lower buyout amount.

⁶ IAS 36 'Impairment of Assets'.

5.11 To achieve a lower settlement amount than 80, it would perhaps be necessary to safeguard against understating the liability by ensuring that the alternative means of settlement is currently available. For example, an entity might believe it could achieve a lower cost of settlement by persuading employees to accept a lower amount in the form of a lump sum cash payment – but unless the employer had the right to do that, it could only be achieved by renegotiating the existing arrangements, which would change the liability that exists today.

5.12 For a means of settlement to be considered to be ‘currently available’, it would be necessary to be within the employer’s control to achieve it. If a means of settlement required employees’ or other parties’ consent, it would not be considered to be currently available.

5.13 A principle that would home in on the lowest settlement amount that is currently available (i.e. within the employer’s control) would scope out of consideration most forms of settlement that are in the field of cash inducements or cash transfers to other benefit arrangements, because these would in general require counterparties’ consent. In practice, the main candidates that are likely to be currently available are (a) running off the liability and (b) buying out the benefits (with a suitable insurance entity), because they are likely to be the only courses of action that would not require consent.⁷

5.14 In the light of the foregoing discussion it is concluded that, if alternative means of settling a liability are currently available to an entity (i.e. it is within the employer’s control to achieve them), the liability should be reported at the lowest amount of the available alternatives.

Options available to employees

5.15 An issue that requires further consideration is how employees’ options regarding settlement should be viewed. Employees may have a raft of choices as to how they may receive their benefits. These may come into effect on or after retirement or when employees leave service before retirement. These choices often involve options to take cash sums in lieu of future pensions. Put simply, a retired employee could elect to receive either a pension worth 100 or an immediate lump sum cash payment worth 90 (or a combination of cash and pension with a value in between). The employee therefore has the right to take the option that is most expensive to the employer but, for reasons akin to those given in paragraph 5.5, the employee may well elect to take the lower value option.

5.16 Two possibilities can be noted. The first is that the employer should report a liability that is based on the higher value, until the employee elects to receive the lower value. Under this view, it would be inappropriate for the employer to take into account assumptions about the rate of take up of the lower cost alternatives, because they are not within the employer’s control – the employee has the right to the higher value, irrespective of whether he or she exercises that right. At first sight, this view appears to be consistent with the principle set out in paragraph 5.14 above.

⁷ Whether or not a buy-out alternative is available without consent may vary from country to country.

5.17 The second possibility is that the liability is measured based on a best estimate or expected value, reflecting the probability of the different outcomes. Some would consider the first possibility to be counter-intuitive and at odds with representation of the economic reality. If it is the nature of the current terms and conditions (provided by contract and/or law) that employees have various settlement options, some believe that reflecting assumptions about the probable outcome is part and parcel of the assumptions used in estimating the future cash outflows and does not invalidate the principle set out in paragraph 5.14 that the means of settlement is currently available to the employer. In this case the means of settlement that is currently available is to settle the liability according to how employees choose to receive their promised benefits.

6 Current value measures of liabilities

Introduction

6.1 The discussion in Section 5 pointed the way to a measurement objective that gives some prominence to the liability being viewed from the perspective of the entity that holds it – that is, reflecting the economic constraints and opportunities available to the entity. This resulted in the proposal in 5.14:

If alternative means of settling a liability are currently available to an entity (i.e. it is within the employer's control to achieve them), the liability should be reported at the lowest amount.

6.2 For a liability that is traded in an active market, the amount stated above would be its market price. The entity would not rationally pay more than the market price to be relieved of the obligation (and nor would another entity or the counterparty rationally accept less than the market price).

6.3 The choice of measurement basis is particularly relevant when liabilities are not traded in active markets – it is perhaps a less significant issue when they are. For a liability that cannot be traded in an active market, a current value has to be estimated. This presently applies to most pension liabilities because, where markets for transferring pension liabilities exist, they are still in their infancy.

6.4 In practice, pension liabilities often have to be estimated by discounting expected future cash outflows, since there is at present no active market for the pension liabilities. Present value is a very useful measurement method as long as we know what the present value that results from the calculation is intended to represent. A present value measurement of future expected payments of pensions would be equal to what the market price would be *if* markets were efficient and at equilibrium; in this situation market value and “run-off” value might be expected to be equal. But as long as there is no active market in pension liabilities, the values will differ. Consideration of an appropriate measurement objective, or premise of value, should give us more insight into what is an appropriate discount rate.

6.5 In addition, for certain types of liabilities, such as benefits that are determined by the value of a portfolio of assets, present value may not be an appropriate method because the liability could be settled

by transferring a specified bundle of assets. An appropriate measurement objective should lead to the most useful measure in these and other circumstances in which discounting future cash outflows may not be the right technique.

6.6 It was noted in Section 5 that the main candidates for settlement that are likely to be currently available are (a) running off the liability and (b) buying out the benefits with a suitable insurance entity. Before discussing those further, we should discuss a third alternative, measures that are derived from regulatory requirements when entities are subject to pension regulation, because regulatory measures often form the basis of employers' obligations to pay cash, and could be viewed as another settlement amount.

Regulatory measures of liabilities

Background

6.7 In many arrangements for the provision of pension benefits, assets are set aside (often in legally separate entities) to provide security for promised benefits and funds for their payment. One area particularly addressed by pension regulation is funding requirements of defined benefit plans⁸. Funding regulation is likely to focus on ensuring that funding of pension plans is adequate and thereby minimising the risk of pension plans not having sufficient funds to fulfil their pension promises. Therefore regulation will seek to provide a framework within which plans are funded to a level to provide some security that the liabilities will be met as they fall due.

6.8 Regulators are faced with the challenge of setting a regulatory regime that monitors funding at an adequate level such that the risk of a pension plan being unable to pay pension liabilities is reduced to an acceptable level. In the EU, for example, legislation has been enacted that requires pension plans to hold assets to cover their 'technical provisions'⁹.

Technical provisions in the EU

6.9 Technical provisions are the amounts required, based on actuarial calculation, to make provisions for the plan's liabilities. A technical provision has been described by a regulator as the amount of money that, if invested at the valuation date, is expected to be sufficient to pay out future pension benefits that have been earned by past service.

⁸ The term 'defined benefit' is used here because it is often used in legislation to determine which plans fall within the scope of funding regulations.

⁹ The EU Directive on Institutions for Occupation Retirement Provision.

6.10 A technical provision is also described as a *funding target*. Characteristics of its measurement include the following:

- it is specific to an individual plan
- it is a prudent measure
- its measurement is less prescriptive than the requirements for measuring pension liabilities in present accounting standards
- it may take into account the strength of the employer's covenant, i.e. reflecting the ability of the employer to step in and contribute more cash if the plan's assets are insufficient to meet its obligations
- the discount rate may assume an element of expected returns on equities if it is considered prudent (e.g. if the employer's covenant is sufficiently strong).

6.11 A consequence of the above is that a sponsoring employer with a weak covenant will, all other things being equal, be subject to a higher technical provision than an employer with a strong covenant.

6.12 Legislation in different countries results in different levels of technical provisions (some require greater margins for prudence than others). However, the consequences of a plan's assets falling short of its technical provisions are common: a recovery plan must be put in place that commits the employer to make good the shortfall, i.e. this is in effect a debt on the employer.

6.13 Regulators can set a framework for funding which results in funding targets either above or below the level of liabilities as calculated for financial reporting purposes under present accounting measures of liabilities. It would seem that divergence is inevitable unless the regulator has the same expectation about the acceptable level of security as is implicit in the level calculated for financial reporting purposes.

Should technical provisions (or other funding measures) be used as financial reporting measures of liabilities?¹⁰

6.14 Sponsoring employers that operate under the technical provision regime are committed to funding on that basis. The amount of technical provision that is determined for any plan will therefore have a direct impact on the level and timing of future cash outflows of the employer. Some would therefore argue that technical provisions (or other comparable funding measures) are most relevant in assessing the entity's future cash outflows relating to its pension obligations and should be used as an appropriate measure of the liability in the sponsoring employer's financial statements.

¹⁰ This Chapter is concerned with the sponsoring employer's financial statements. Chapter 11 discusses the same issue from the perspective of the pension plan's financial statements.

6.15 This paper does not support the idea that regulatory measures of liabilities to pay benefits should replace measures derived from general accounting principles, because their principal purpose concerns the solvency of pension plans, by specifying a level of assets that must be set aside in separate funds to be available to meet the obligation to pay benefits. Thus they do not purport to provide financial statement users with decision-useful information *per se* about the amount of the underlying obligation to pay benefits.

6.16 Regulatory measures that are used to determine a prescribed level of funding clearly give rise to cash outflows from the entity's general resources into the resources that are set aside to provide separate funds for the payment of benefits. But the following points may be noted in support of the view that regulatory measures may not provide the most appropriate accounting values of the obligation to pay benefits:

- regulatory measures do not reflect the full extent of the underlying obligation because, as noted above, they may understate the potential liability of the sponsor because of the way the employer's covenant is reflected;
- if such measures were used to report the employer's liability, an employer with a weak credit rating would report a larger liability than an employer with a strong credit rating for the same underlying benefit obligation, which has the *opposite* effect to that when credit risk is reflected in the measurement of other liabilities, because reflecting greater credit risk conventionally leads to smaller liabilities (see Section 7);
- regulatory measures in different countries may not be comparable because different governments prescribe different funding targets.

6.17 The debate about regulatory measures has similarities to the debate about actuarial measures of liabilities that preceded the present pensions accounting standards. Such measures tend to assume that part of the liability will be met out of future cash flows from assets and ignore the employer's obligation to pay more contributions if the assets do not perform as expected. The view that such measures do not provide current values of the liability is articulated in the following extract:

"It is important to appreciate that valuation is not the final objective of a funding methodology. Instead, the ultimate requirement is to come up with a funding plan, confirming that, under plausible business assumptions, the assets are sufficient to pay benefits or that assets plus future contributions will be enough to pay future benefits. If the assets are expected to earn a high return, for example, on account of their riskiness, it could be argued that it is appropriate to take this into account when drawing up a funding plan, particularly given the special circumstances of having an underlying promise to pay from the employer.... In other words, although the funding basis is weak and the pension fund assets may not be sufficient to meet the promised benefits, the additional security afforded by the employer results in an overall acceptable level of risk. The liabilities are not being 'valued' but rather budgeted for."

(Exley, Mehta and Smith 1997 'The financial theory of defined benefit pension schemes', para 3.2.5)

6.18 Although this paper takes the position that regulatory measures are for funding, not accounting, users may be interested in knowing what such regulatory measures are, because of the close relationship between them and contribution requirements (including recovery plans). The case for disclosure of alternative measures of liabilities, including regulatory measures, is discussed in Chapter 9.

6.19 This paper concludes that regulatory measures of liabilities to pay pensions should not replace measures derived from general accounting principles.

'Run-off' and 'buy-out' measures

6.20 We use the term 'run-off' as shorthand for the situation where the employer continues to administer the liabilities and pays benefits when they fall due, either from its internal resources or from assets that have previously been set aside.

6.21 In the present state of markets for such liabilities, the price of buying out is often higher than a 'run-off' measure (as calculated under present pensions accounting standards) because a potential transferee would factor things into the price that the entity would not. If the prices were the same, the entity should be indifferent as to whether to transfer the liability or continue to hold it.

6.22 Reasons why the measures might be different include the following:

- (a) The transferee entity would typically be an insurance entity.¹¹ Pensions and insurance activities may be subject to different regulatory regimes. If an insurance entity is subject to stricter regulatory capital requirements, a liability transferred to it will have less credit risk after its transfer. This would add value to the liability (and, from the employee's perspective, add value to his or her right to receive benefits).
- (b) Participants in the market make different risk assessments relating to the liability than the entity. For example, risk appetites may differ between the entity and any potential transferee in relation to mortality risk (the transferee is likely to be more risk averse), which would be reflected in the compensation that the transferee would require for assuming that risk. (This reason is probably linked to the point in (a) – to sustain a high credit rating, a transferee would be likely to make more conservative assumptions about mortality risk.)
- (c) Participants in the market demand a premium for the risk that the information provided by the entity is incomplete or misleading – in other words, a purchaser may be less sure than the seller exactly what risks it is taking on.

¹¹ That is, on a going concern basis. The transferee entity could be a statutory protection fund, but that would typically come into play in an insolvency situation.

- (d) Future expenses of administering the liability would be factored into the price that a transferee would require – currently they are usually excluded from the measurement of the liability on an ongoing basis. (However, this paper proposes that expenses of settling the liability should be included in both measures – see Section 8.)
- (e) The transferee will only accept a transfer at a price that includes some profit – even when all of the above (and any other factors, such as the cost of servicing regulatory capital) have been taken into account.

6.23 Some have suggested that the gap between ‘run-off’ and ‘buy-out’ measures will become smaller as more entities enter the transfer market, including entities that are not subject to the more stringent insurance regulations.

6.24 The measurement basis in IAS 37 (and its proposed revision) for provisions¹² provides a useful starting point. It reflects the lowest amount that an entity would rationally pay *on the balance sheet date* to be relieved of the obligation. The objective would therefore be to report a *current* settlement amount, but it would appear to rule out a buy-out measure that the entity would not rationally pay. There will often, therefore, be no rational alternative to running off the liability.

6.25 A current value measure of future payments of pension benefits reflects *today’s value of the future cash outflows expected to settle the liability when it falls due*. This would usually be the amount that fulfils the objective in paragraph 5.14, because a buy-out amount would usually be higher. However, if the liability could be transferred for a lower amount, reporting the liability at that lower amount would fulfil the objective.

IASB’s proposals for insurance liabilities

6.26 It is useful to read across from the approach to measurement of insurance liabilities that is advocated in IASB’s Discussion Paper ‘Preliminary Views on Insurance Contracts’ (May 2007). That paper sets out three basic ‘building blocks’ for measuring insurance liabilities when a present value measurement is required:

- (a) explicit, unbiased, market-consistent, probability weighted and current estimates of the contractual cash flows
- (b) current market discount rates that adjust the estimated future cash flows for the time value of money
- (c) a risk margin reflecting the margin that market participants require for bearing risk (and a service margin in respect of other services provided, if any).

¹² IAS 37 defines a provision as ‘a liability of uncertain timing or amount’.

6.27 The above approach to measurement is described as *current exit value*, although it may be noted that the IASB has stated that it has not identified significant differences between that approach and *fair value*. They both purport to reflect the amount an entity would have to pay to transfer a liability to another entity at the reporting date. (A description of the characteristics of a fair value measurement for liabilities in the IASB's Discussion Paper 'Fair Value Measurements' (November 2006) is given in Appendix D.) Current exit value (or fair value) differs significantly from the measurement approach in IAS 19 and it is clear that the IAS 19 approach generally produces a lower measure of a liability:

Insurance liabilities (IASB DP)	Pension liabilities (IAS 19)
Expected value of cash flows (market-consistent estimates)	Expected value of cash flows (entity's best estimates)
Discount at risk-free rate	Discount at high quality corporate bond rate
Add a market margin	No margin added

6.28 Some disagree with certain implications of using fair value (or current exit value) as a measurement objective for pension liabilities. Views include the following:

- (a) Some consider fair value (or market-based exit value as it is described in the IASB's Fair Value Discussion Paper) to be an inappropriate measurement objective when (as is usually the case) pension liabilities are not traded in active markets, because extensive use would be made of valuation techniques using inputs in the 'Level 2' and 'Level 3' categories.
- (b) Markets to which an entity might have access (e.g. transfer of a liability to an insurance company, or 'buy out') do not give rise to transactions that are comparable to the hypothetical transactions envisaged. That could lead to an entity having to report a prohibitively expensive transfer amount when it would not rationally pay that amount to discharge its obligation.
- (c) A fair value measurement explicitly requires the credit (or non-performance) risk relating to that liability to be reflected. Thus it seems clear that if the measurement objective is fair value (or current exit value), funding or collateralisation of the liability will increase its fair value and should be taken into account in its measurement. Some believe it is inappropriate to include credit (or non-performance) risk in the measurement of pension liabilities (different viewpoints are considered in Section 7).
- (d) A transferee would only accept a transfer at a price that includes some profit. Some believe that the inclusion of someone else's profit margin in the measurement of an entity's own liabilities does not necessarily provide useful information about the amount, timing and uncertainty of cash outflows from the liability that the entity holds. Some believe that this point applies more generally to the assumptions that underlie a hypothetical transfer price, particularly when no

market exists to transfer the liability. (Others do not believe this is a valid argument because the entity holding the liability also requires a profit to achieve a return on its own equity; in their view, this profit requirement – or, more correctly, compensation to the equity for risk when holding risky assets and liabilities – is the same as a buyer would require. Hence, in their view, there would be no difference in pricing between a transferee and the value the entity owning the liability would calculate based on this argument.)

- (e) Some believe that the objective on initial recognition – to measure the liability incurred in exchange for the services rendered (as discussed in Section 4) – suggests that an *entry value* measurement objective, reflecting the price that would be received to assume the liability, is more appropriate than an *exit value* measurement objective, which reflects what the entity would have to pay to transfer the liability.
- (f) Until further work is done on defining the ingredients of fair value for liabilities generally, it would be difficult to determine whether the approach taken in Chapter 2 in relation to defining a pension liability would be affected by a fair value measurement objective. For example, this paper has approached the issue of whether future salary increases should be reflected in the measurement of a liability as an interpretation of the definition of a liability, and is not dependent on conclusions on how the liability should be measured.

6.29 On the other hand, some believe that any approach should be consistent with using fair value if deep and liquid markets in the transfer of pension liabilities were to develop in the future. They would then be more comfortable that an exit value approach (interpreted in this case as the current market price) would give the most appropriate measure of the liability at the balance sheet date.

6.30 As discussed above, it is the absence of an active market for transferring pension liabilities that causes many to doubt that fair value (as described in the most recent literature) is the most appropriate measurement objective. They believe in an approach that does not include another party's profit margin or risk margin in the measurement of an entity's own liabilities. This approach might be viewed as an 'entity-specific' measurement, because it aims to reflect not only the properties of the liability itself but also the relationship to its owner.¹³ Some believe an entity-specific measurement is appropriate, particularly when there is no transfer market for the liability (except perhaps a transfer to an insurance entity). We might expect market-based measures and entity-specific measures to converge, however, as the time horizon of the liability decreases and uncertainty is reduced.

Entity-specific value compared with current exit value/fair value

6.31 If an 'entity-specific' measurement were used for pension liabilities, how might it differ from the proposed current exit value model for insurance liabilities?

¹³ IASB's Glossary of Terms describes an entity-specific value of a liability as "the present value of the cash flows an entity expects to incur when settling a liability".

6.32 In many cases, except for the inclusion of credit risk in current exit value, we would not expect the two approaches to differ. For example:

- for benefits that depend on the value of a pool of assets (actual or notional), the liability would be measured under either approach by reference to the current market values of those assets
- for benefits that depend on the value of a pool of assets and include, additionally, a guarantee given by the employer related to the assets' investment performance, the liability in respect of the guarantee would be measured like a derivative financial instrument.

6.33 For other types of benefits, such as pensions that depend on length of service and salary, a current value measure will be derived from discounting expected future cash flows. Returning to the three 'building blocks' set out in paragraph 6.26 above, the following points may be noted.

Expected value of cash flows

6.34 In general, the measures of cash outflows in building block (a) under the two approaches would not be expected to differ significantly. Whilst an entity-specific approach would allow an entity to factor its own best estimates into measurements, it would not entitle management to ignore market evidence of value. In other words, an entity should use market-consistent information when it is available and relevant to the entity. Those who support an entity-specific approach nevertheless believe it would be wrong to use information that is inconsistent with information that is available in the market.

6.35 On the other hand, if an entity has better information about specific attributes of its liability, some believe it should use that because in their view it is more relevant to understanding the entity's financial position. For example, it might not be appropriate to insist on market-based measures for mortality assumptions, since mortality rates can be specific to an entity (such as when an entity knows that the longevity of its workforce is not as good as the market view). Similarly, future expenses of administering the liability are likely to be entity-specific estimates under this approach.

6.36 Discussion concerning the definition of liabilities (in Chapter 2) has set out different views on whether the level of future pensionable salaries or estimates of future discretionary pension increases should be factored into the measurement of the liability. If either of those possible future benefits were reflected, it seems that under either approach an entity's own best estimates would be required of the cash outflows needed to settle those elements of the liability, because it would not be possible to transfer such a liability to another entity and no other 'market consistent' estimate could be made.

Current market discount rates for the time value of money

6.37 The discount rate in building block (b) would under either approach be purely for the time value of money, i.e. a risk-free rate. There is little guidance in the insurance discussion paper on determining this rate, except that it is *not* derived from expected returns on actual assets held. Contributors to this discussion paper concur with that view. There is, however, some debate about whether a risk-free rate is

derived from a yield curve for government bonds or from an interest rate swaps curve (as a more liquid alternative with longer maturities available), and it is suggested that further consideration should be given to this.

6.38 In contrast, IAS 19 requires pension liabilities to be discounted by reference to market yields at the balance sheet date on high quality corporate bonds (or, in countries where there is no deep market in such bonds, government bonds) of a currency and term consistent with the currency and term of the obligation. The relevant paragraphs from the IASC's Basis for Conclusions to IAS 19 are included in Appendix E.

6.39 The IASB decided (paragraph 31 in the Basis for Conclusions in Appendix E) that the discount rate should reflect the time value of money but should not attempt to capture the risks associated with a defined benefit obligation or an entity's own credit rating. They considered the rate that best achieves these objectives is the yield on high quality corporate bonds. (The guidance in SFAS 87/SFAS 106 also takes rates of return on high-quality fixed-income investments as reflecting only the time value of money).

6.40 On the other hand, FRS 17 relates the yield on a high quality corporate bond to the objective of reflecting a *risk-adjusted* rate, i.e. a rate that reflects both the time value of money and the characteristics of the liability. The ASB's rationale for the above discount rate is set out in Appendix IV to FRS 17. The relevant paragraphs are included in Appendix F to this Chapter. It is noteworthy that a *higher* than risk-free rate is justified here on the grounds of the various options available to an employer to reduce benefits, or to refrain from increasing them. In effect, that discount rate is intended to reflect two offsetting factors: (a) a price for the uncertainty of future cash outflows (which increases the value of the liability) and (b) the aforementioned options (which reduce the value of the liability).

6.41 The following points may be noted in relation to that rationale:

- (a) The discussion about liabilities in Chapter 2 of the discussion paper is in the context of determining which cash outflows should be reflected in the measurement of a pension liability. The view that emerges is that the effect of discretionary behaviour would be excluded, along with possible future changes in benefits that are not present options of the employer. Also, if future salary levels were not reflected in the liability, the question of how to reflect the employer's discretion over future increases in pensionable salaries would no longer be relevant.
- (b) Accrued benefits that have been earned by employees cannot be reduced by the employer (at least in the present environment in the UK and most other countries that we have canvassed) and cannot be avoided by closing down a plan.
- (c) For liabilities in respect of benefits that have not vested, assumptions underlying the estimates of cash flows would already reflect the probability that vesting conditions will not be fulfilled.

Risks in pension liabilities

6.42 An important issue that might divide the two approaches is whether the measurement resulting from applying building blocks (a) and (b) should be adjusted for a risk margin (as in building block (c)) and, if so, how should it be measured for a pension liability.

6.43 As is demonstrated in the discussion below, solving the issue of a risk margin is proving elusive. It has been noted that, in the debate about insurance liabilities, some believe that an 'entry price' risk margin should be used rather than an estimate of the margin that other market participants would require for bearing risk. But if that view were applied to pension liabilities, there remains a big question regarding how to measure that margin because (unlike insurance contracts) there is usually no observable entry or transaction price for assuming the liabilities.

6.44 It might be helpful to consider a pension liability as giving rise to two types of risks:

1. Risk/variability of the size of the pension claim.
2. Risk that there is insufficient cashflow/assets in the company to pay the pensions (credit risk).

6.45 The first is the risk that the actual pension payments will differ from today's expectations, when assumptions have been made about the uncertainties that will affect the amount of benefits to be paid, such as mortality rates and (for those who believe they should be taken into account) future salary levels.

6.46 The second, credit risk, is discussed in Section 7 where it is concluded that it is inappropriate for an employer's liability for pensions to be reduced to reflect the employer's own credit risk.

6.47 The approach in the insurance discussion paper to the risk of the size of the claim is similar to adjusting the expected value of the cash outflows to a 'certainty equivalent'. The thinking is that a liability with an uncertain cash outflow that has an expected value of 100 is usually more onerous than a liability with a certain cash outflow of 100. In other words, an entity would want to be compensated for the uncertainty and would therefore demand to be paid more to assume the uncertain liability than to assume the certain liability (based on the assumption that investors are risk averse)

6.48 Some have suggested that a risk premium should *only* include the systematic or non-diversifiable risks. These are held to be risks that cannot be diversified away from by holding a large portfolio of pension liabilities or similar assets and include in particular the risk that mortality rates in the future will be different from today's estimates and the risk that real salary increases in the future will be different from today's estimates (the latter assumes, of course, that future salary levels are reflected in some pension liabilities, which as discussed in Chapter 2, is a treatment that many do not agree with). The theory is that in efficient markets, only non-diversifiable risk will be priced because the market will not charge for other risks that it can offset by diversification.

6.49 Furthermore, different views are held on whether the value of a pension liability is *increased* or *decreased* with non-diversifiable risk such as the mortality risk that cannot be hedged. For example, some claim that a risky liability could be discharged more efficiently by the cash flows arising from a portfolio that includes some risky assets than the cash flows from a portfolio of risk-free assets (because the risks are offsetting) and that the liability should therefore be measured with reference to the value of the most efficient portfolio of assets.

6.50 It may be noted that under the proposals in the insurance discussion paper, the direction of an adjustment for risk of the size of the claim is to *increase* an insurance liability. Most contributors to this paper would agree that the effect of conveying to an employer the risk that it will have to pay more benefits if people live longer than expected is to make a pension liability more onerous than it would be if the risk were borne by others – it has been likened to an employer writing a call option that can be exercised by people living longer.

6.51 A matter on which all would agree is that a risk margin for a pension liability is very difficult to measure. Many would go further, taking the view that some risks (for example, those relating to future changes in mortality) are ‘unknowable’ and therefore cannot be quantified. Under this view, it would be misleading to try and reflect the financial effect of such risks in reported liability amounts, say, by attempting to construct a theoretical entry price. Accordingly, under this view, users are better served by disclosure about the assumptions that have been used in the estimates of the cash flows and the sensitivity of the liability to changes in those assumptions (see Chapter 9).

6.52 The following table expands that in paragraph 6.27 to reflect the foregoing discussion, adding a possible basis for measuring pension liabilities under an entity-specific view of the liability:

Insurance liabilities (IASB DP)	Pension liabilities (IAS 19)	Pension liabilities (entity-specific view)
Expected value of cash flows (market-consistent estimates)	Expected value of cash flows (entity’s best estimates)	Expected value of cash flows (entity’s best estimates)
Discount at risk-free rate	Discount at high quality corporate bond rate	Discount at risk-free rate
Add a market margin	No margin added	No margin added Disclose sensitivities of assumptions

6.53 The foregoing discussion may be summarised as follows:

- The objective of a current value measure of future payments of pension benefits is to reflect today's value of the future cash outflows expected to settle the liability when it falls due. This approach might be viewed as an 'entity-specific' measurement, because it aims to reflect not only the properties of the liability itself but also the relationship to its owner. Where this measure is derived from discounting future cash flows it should reflect:
 - expected value of cash flows (entity's best estimates) that would be admitted under the proposals in Chapter 2
 - current market discount rate to reflect the time value of money only, i.e. a risk-free rate.
- In theory the liability should also reflect a margin for risk, but there is concern that some risks (for example those relating to future changes in mortality) are 'unknowable' and therefore cannot be quantified. Accordingly, users are better served by disclosure about the sensitivities of the liability to changes in the assumptions that have been used in arriving at the best estimates.

7 Credit risk of liabilities

Background

7.1 A pension liability may be viewed as a claim to (some of) the entity's assets and cashflows. Hence, there is a risk to the *beneficiary* that the promised pension will not be paid, and a risk to the *company* that the actual payment of the liability will differ from the full amount of the claim, in the event that the sponsor becomes insolvent. This is particularly so if the liability is unfunded, i.e. no assets have been set aside to provide funds for settlement of the liability. On the face of it, the higher is the risk of default the lower is the value of the pension promise to the beneficiary.

7.2 A particularly complex and contentious issue is whether the risk that an entity will default on its obligations should be reflected in the measurement of the liability. This risk is reflected in an entity's credit rating. An entity with a lower credit rating will pay a higher interest rate on its borrowings. The present value of a liability discounted at this higher 'risk inclusive' rate will be lower than for an entity with a higher credit rating.

7.3 The effect of including credit risk (sometimes referred to as non-performance risk) in the measurement of pensions and similar liabilities is to measure the cost of services received, and the liability incurred, at a lower amount than if it were excluded (assuming, of course, that the effect of credit risk on the measurement of the liability is significant). The amounts by which liabilities are reduced to reflect credit risk would subsequently be 'unwound' over the lives of the liabilities by accruing a higher rate of interest.

7.4 Accounting standard setters have taken the view in some recent pronouncements and proposals that credit risk should be reflected in the measurement of liabilities (e.g. SFAS 157 *Fair Value Measurements*, SFAS 143 *Accounting for Asset Retirement Obligations*, Statement of Financial Accounting Concepts No.7 *Using Cash Flow Information and Present Value in Accounting Measurements*, IASB Discussion Paper *Measurement Bases for Financial Accounting – Measurement on Initial Recognition*, IASB Discussion Paper *Preliminary Views on Insurance Contracts*).¹⁴ But credit risk is not reflected in the requirements of existing standards on pensions and other post-employment benefits (for example, IAS 19, SFAS 87, SFAS 106, FRS 17) or in IAS 37 on provisions.

7.5 The issue is further complicated by the impact of regulation on many pension providers. Governments in many jurisdictions have put procedures in place (e.g. by implementing policies that require an appropriate level of segregated assets and/or statutory protection of benefits) that are intended to immunise pensioners and employees from the risk that pension promises will not be kept. Thus if a liability is collateralised with segregated assets, the liability is free from credit risk – or, perhaps more accurately, credit risk is focussed entirely in the liability, if any, that is not covered by the assets. But in most cases pensioners and employees will have some exposure to the risk of default and so the issue has wide relevance.

7.6 Looked at another way, if an entity takes out an unsecured loan, the finance cost (i.e. the difference between the consideration received and the payments the debtor is required to make to the creditor) will reflect a price for the entity's credit risk. If, however, the entity pledges assets as collateral for the loan, it will in general achieve a lower cost of borrowing because the risk that the creditor will not be paid is reduced.

7.7 The issue therefore concerns the credit risk of the liability rather than the credit risk of the entity. Among the implications of including credit risk in the measurement of a pension liability are:

- (a) The issue is only relevant where such a risk actually exists.
- (b) Liabilities that are unfunded would be measured differently than liabilities that are funded (where much of the credit risk is taken out by collateralisation); and liabilities that are fully funded would be measured differently than liabilities that are only partly funded.
- (c) When liabilities are measured on the basis of an estimate of present value of future cash outflows, discount rates would not be uniform; they would reflect the price of credit risk for the liability concerned.

7.8 Members of the advisory groups hold alternative views on whether or not an employer's liability for pensions should be reduced to reflect credit risk. The main arguments for the different viewpoints are

¹⁴ It should be noted, however, that the inclusion of credit risk in liabilities addressed by those pronouncements assumes a measurement at fair value (or, in the case of insurance liabilities, current exit value).

set out below.

Arguments for including credit risk

7.9 Arguments for including credit risk include the following:

(a) It was noted above (in Section 6) that a pension liability has two types of risks:

-the risk/variability in the size of the pension claim (this risk is independent of the financial position of the employer).

-the risk that there is not sufficient cash-inflow from the assets of the employer to pay the claim. (A liability in finance theory is viewed as a contingent claim on the company's assets and cash-inflows, as an option; *if* there is sufficient cash-in-flow to settle the claim, *then* the claim will be settled).

-Hence a company's liabilities are always related and inseparable from the company's actual business and financial risk. This risk cannot be diversified away by holding a high portfolio of liabilities; if there is a general downturn in the economy, all liabilities that do not have claims from 100 % certain cashflows/assets will decrease in value. Moreover, the relative values of liabilities also change over time when the risk changes; liabilities normally have different priorities to the assets/cashflows. When the values of the assets decrease, the high-priority liabilities will decrease little, but the low-priority liabilities will decrease more in value. Hence, relatively the high-priority liabilities will increase in value. The risk premium for insufficient cashflows to pay the claim/liability therefore includes both systematic and firm specific risk – only if a liability has priority in 100 % secure and sufficient assets, the liability has no credit risk.

(b) Liabilities incurred in exchange for services should not be treated differently from liabilities incurred in exchange for cash.

Liabilities incurred in exchange for cash are generally measured (on initial recognition) at the amount of cash received. This amount is representative of the future cash payments that the borrower is obliged to make, discounted at a rate that reflects the risk of default.

Thus two borrowers of different creditworthiness that each agree to repay £100,000 in three years time will report different liability amounts because the less creditworthy borrower will receive a smaller amount of cash than the more creditworthy borrower. As a consequence the less creditworthy borrower reports a higher interest cost.

If credit risk were taken out of the initial measurement of liabilities incurred in exchange for cash (i.e. the cash payments were discounted at a risk-free rate), each entity would report a loss when it issued the debt (the amounts would differ, however) and report the same interest cost thereafter. Such a model is not contemplated in current accounting requirements for liabilities incurred in exchange of cash.¹⁵

Under this view, the current accounting treatments of liabilities incurred in exchange for services and for cash are inconsistent. An effect of the inconsistency is that the pension cost currently reported by an 'AAA-rated' company is too low under IAS 19 and the pension cost currently reported by a 'BBB-rated' company is too high.

- (c) The price of the exchange of services for the promise of a pension reflects the risk that the promise will not be met. Stated differently, the value of the benefit to employees would reflect the credit risk in the amount promised.

Consider the following example:

- Assume the market rate of pay for an employee is 10,000. Any employer, whether of high or low credit standing, would have to pay this in a competitive market.
 - Now assume that 10% of that pay is represented by a pension promise. Both a high and low credit risk employer will have to provide a pension worth 1,000 but this means (assuming full information and a perfect market) that the high credit risk employer will provide a promise of a higher future pension payment to compensate for the credit risk suffered by the employee.
 - The value of the services provided by both employees is 10,000. Only by allowing for credit risk in measuring the pension liability is the proper price of the exchange reflected in profit or loss.
- (d) Credit risk affects the price at which liabilities could be repurchased or settled.¹⁶

For example, if an entity borrowed cash to settle an unfunded or partly funded pension liability, the price of borrowing would reflect credit risk. It is therefore appropriate to allow for credit risk in measuring the unfunded part of such liabilities.

Furthermore, in the example given in (c) above, the employee with the low credit risk employer would not allow the liability to be transferred to the less creditworthy entity without compensation.

¹⁵ An alternative would be to consider reporting the difference between the risk-free measure and the consideration received as an asset, reflecting an option to put the liability back to the lender in the event of the borrower becoming insolvent.

¹⁶ See for example IAS 39 (BC89) which states the case for the requirement for the inclusion of credit risk in the fair value measurement of a financial liability.

- (e) A less creditworthy entity would report a liability at a smaller amount than a more creditworthy entity would report a similar liability, but the smaller liability is likely to be accompanied by a lower value placed on the entity's equity and assets.
- (f) When the risk that pensions will not be paid is reduced, pensioners' rights to benefits become more valuable and there is a corresponding increase in the economic cost to the entity. For example, if an entity decides to secure its liability either by ring-fencing it with risk-free assets or by transferring it to an entity of higher credit-standing, the promised benefit becomes more valuable to the pensioners. The credit enhancement of the liability is a cost to the entity (in effect the company has to buy it). It is to be expected that the entity should then report a loss and an increase in its liability.

Arguments for not including credit risk

7.10 Arguments for not including credit risk include the following:

- (a) The going concern concept requires the assumption to be made that an entity will settle its liabilities in full.

The going concern concept is described in the current Framework as an underlying assumption on which financial statements are prepared: "financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future".¹⁷ The going concern assumption supports the principles that allow assets and liabilities to be reported on a basis that their carrying amounts will be recovered or settled in the normal course of business, rather than reflecting the amounts that would be recoverable or payable if the business were liquidated. It is not appropriate under this assumption to reflect the risk that an entity might not be able to pay its liabilities in full (or that it can avoid paying them); rather it is for the entity to report the true burden of its obligation and the market to evaluate what the entity can afford to pay.

- (b) Reducing an entity's pension liability to reflect the credit risk of the liability is not useful information for users who wish to assess the entity's cash flow prospects as it does not help them to assess the amounts, timing and uncertainty of the cash outflows from its obligations.

Other accounting standards that require credit risk to be included in the measurement of liabilities do so in the context of a requirement to measure the liability at fair value. A fair value measurement would reflect the price at which the liability could be transferred to another entity of comparable credit standing. However, an entity that holds a pension liability has no opportunity to settle or transfer it in a way that reflects credit risk (assuming it continues as a going concern). For example, an insurance company would demand the same amount to assume the same liability from a high credit risk or a low credit risk entity. Thus the opportunity that may exist in respect

¹⁷ IASB Framework, paragraph 23.

of a corporate bond – where it may be possible to repurchase the bond in the market at a price that reflects the market's discount for the risk of default – is not available for a pension liability. Therefore, it is not relevant to reflect credit risk in liability measurement for the purpose of assessing the entity's own cash flow prospects.

Furthermore, including credit risk may convey the misleading impression that an entity has an option to default on its obligations.

- (c) In the real world, the level of pension promises received by employees does not vary perceptibly by reference to credit risk, so the assertion that the price of the exchange of services for the promise of pensions reflects the risk that the promise will not be met is not valid.
- (d) Liabilities incurred in exchange for promises of pensions are generally treated differently from liabilities incurred in exchange for cash *after* initial recognition.

Liabilities, such as corporate borrowings, incurred in exchange for cash are generally measured on *initial* recognition at the amount of cash received (which reflects credit risk). However, they are usually measured *after* initial recognition at amortised cost. Thus the carrying amounts are not subsequently adjusted for changes in economic conditions such as changes in market rates of interest or the price of the credit risk of the liabilities.

This Chapter proposes, however, that a liability in respect of future pensions should be measured at a current value (see Section 3). In a current value approach, liabilities should be measured on a consistent basis on initial recognition and subsequently. That means credit risk should be either in or out of all measurements, and it would be inappropriate to reflect credit risk on initial recognition and not to reflect changes in credit risk in subsequent remeasurements.

Accounting for credit risk in financial liabilities has not been resolved internationally. Many disagree with the view that entities should report the effect of *changes* in credit risk on their borrowings as gains or losses – in particular, some believe it can have a perverse effect of making an entity that is becoming insolvent appear solvent and profitable. In the light of present accounting requirements for other liabilities, it would therefore be premature to require pension liabilities to be measured to reflect credit risk in both initial and subsequent measurements.

(An illustrative example which compares the treatment of credit risk in a liability incurred in exchange for cash and a liability incurred in exchange for services is given in Appendix C.)

- (e) Related to the point in (d), the economic cost of reducing the credit risk of pension liabilities by credit enhancement is likely to be borne by shareholders and holders of an entity's other liabilities. For example, other bonds might become more risky as a result of the entity pledging assets to its pension fund and their value might fall. If the pension liabilities were remeasured to reflect changes to their credit risk, the entity's financial statements would misrepresent the financial position and profit or loss of the entity unless other liabilities were remeasured to reflect the consequential changes to their credit risk.
- (f) Credit risk is too difficult to measure, because it is affected by the business risk of the entity/entity's assets, the credit risk of the entity and whether the entity's pension liabilities are funded by separate/prioritised assets. Moreover, it is not the same as the general credit rating of the entity, because this credit rating is probably related to liabilities with other priorities and other secured assets than pension assets. In addition, most entities are unlisted entities that do not have a credit rating; for them, it is impracticable to obtain a market price for the credit risk of their pension liabilities.
- (g) It has been noted that for funded schemes the period over which any deficit is expected to be funded by the sponsoring entity is unlikely to coincide with the period over which the liabilities to pay benefits are settled. For example, the latter may stretch out to 85 years whereas the sponsor may have an obligation to eliminate a deficit over a much shorter period, say 5 years. If there is a theoretical rationale for including credit risk in relation to the period in which the deficit is expected to be funded, it is questionable whether that provides useful information.

7.11 Members of the ASB have found the arguments against the inclusion of credit risk convincing. Accordingly, it is concluded that it is inappropriate for an entity's liability for pensions to be reduced to reflect its credit risk.

8 Expenses of administering liabilities

8.1 The accounting treatment of expenses of operating pension plans receives little attention in accounting standards. IAS 19 requires expenses to be deducted from the return on plan assets, unless they have been reflected in the measurement of the defined benefit obligation; there is no guidance as to which costs are required or permitted to be reflected in the measurement of the obligation.

8.2 The present accounting requirements appear to be unsatisfactory, although some would argue that, in the context of their materiality, managements and their advisers could be expected to reach an appropriate accounting treatment of most plan administration expenses without further guidance. However, in some cases, plans are subject to significant expenses that were not contemplated when the accounting standards were written; an example is premiums charged by government-sponsored guarantors of defined benefit pension plans.

8.3 The types of expenses that are typically incurred in providing pension benefits might be broadly categorised as follows:

- (a) expenses of administering the plan's assets;
- (b) expenses of administering the plan's benefits;
- (c) levies and taxes on the plan.

Expenses of administering the plan's assets

8.4 Expenses of administering the plan's assets, such as future investment management expenses, are not considered to be present obligations. They are within the entity's control (and, hence, avoidable) in the sense that the entity's future investment strategy will determine whether, and how much, expenses are incurred.

8.5 Furthermore, assets could be sold for cash at the values reported under the measurement model for assets (see Chapter 6) without incurring further costs. Put another way, it can be argued that the current values at which assets are reported in the financial statements already reflect future costs that holders have to bear.

Expenses of administering the plan's benefits

8.6 All expenses that are not expenses of administering the plan's assets must relate to administering the plan's benefits. Such expenses would include staff costs, trustees' remuneration, actuaries' and auditors' fees, legal and professional expenses.

8.7 It is considered that, conceptually, expenses of administering *accrued* benefits should be reflected in the measurement of the liability and expenses of administering *future* benefits should be excluded, for the following reasons:

- (a) The liability cannot be settled without incurring expenses. It is clear that the expenses that a third party would incur to administer the liability would be reflected in a transfer price. Similarly, an employee acting rationally would expect administration expenses to be met in the case of a direct employer-employee settlement (so that the employee could, for example, purchase an annuity from a third party). Similarly, expenses cannot be avoided if the entity continues to hold the liability and runs it off.
- (b) Inclusion of such expenses would also be consistent with the view that they are part of the economic cost of providing the promise of post-employment benefits. This becomes more evident in the case where a scheme has been closed to future service benefits and hence all the future administration expenses relate to the administration of accrued benefits.

8.8 In the light of the foregoing discussion it is concluded that measurement of the liability should reflect expenses of administering the plan's accrued benefits.

Levies on the plan

8.9 This section considers the treatment of premiums relating to government guarantee schemes. The model of pension protection levies in the UK has been considered because it provides an interesting case study.

8.10 The levy on UK pension plans is comprised of two elements:

- (i) an amount that is a fixed percentage of each scheme's liabilities
- (ii) an amount that is derived after taking into account the level of a plan's underfunding and the risk of the sponsoring employer becoming insolvent.

8.11 Views are divided as to whether measurement of the liability should reflect future levies. The main arguments for the different viewpoints are as follows.

Arguments for not including future levies

8.12 Arguments for not including future levies include the following:

- (a) Levies are analogous to taxes on pension plans (or indeed on the companies that operate them) which are usually treated as period costs.
- (b) There are analogies with IFRIC Interpretation 6 on waste electrical and electronic equipment. IFRIC 6 concludes that no present obligation exists for future waste management costs until an entity participates in the market during the measurement period. A principal basis for that conclusion is that the obligation is created only by the future actions of the entity, i.e. participating in the market in that period. Likewise, the levy incurred in each period is a cost that is derived from an aggregate levy that is allocated to eligible schemes that exist in each period – it may therefore be regarded as a cost of doing business (i.e. of maintaining a defined benefit pension scheme) in each period.

Arguments for including some future levies

8.13 Some believe that the element in paragraph 8.10(i) should be reflected and the element in 8.10(ii) should not be reflected.

8.14 In their view, the amount that is levied as a percentage of each plan's liabilities is akin to an unavoidable expense of administering the liability for the life of the liability.

8.15 They believe, however, that the amount that is based on the plan's overall funding position and the sponsoring company's creditworthiness for each period that the levy is assessed is different because it relates to the future structure of the entity's balance sheet and its funding decisions.

8.16 Under this view an entity could choose to take action to mitigate future levies, or even avoid them, by reducing the risk that a plan poses to the government sponsored guarantor. It could do this by, for example, taking steps to reduce underfunding (by paying additional contributions to the fund) or entering into arrangements (through guarantees, security over other assets, etc) whereby the fund will receive cash if the sponsoring employer becomes insolvent.

Arguments for including all future levies

8.17 Some others would not distinguish what should be included or excluded on the basis of how the formula for allocating levies operates. They believe that future levies are an unavoidable cost of keeping the plan in existence; an entity may be able to mitigate by its own actions the amount of future levies that are imposed on it, but it can't avoid them because the amount also depends on the actions of others (for example, a contributor will potentially be required to pay more if other contributors become insolvent). They also believe that the effect of actions that might be taken in the future, such as those referred to in paragraph 8.16, which would reduce the risk of default and, as a result, reduce future levies, should not be taken into account in the measurement of liabilities until such actions are taken.

9 Summary

9.1 The views in this Chapter may be summarised as follows:

- (a) A liability in respect of future pensions should be measured at a current value. (Section 3)
- (b) A current value measure will be a 'settlement amount', reflecting a measure of the cash outflows (or other transfers of economic benefits) needed now or in the future to discharge the liability. (Section 4)
- (c) If alternative means of settling a liability are currently available to an entity (i.e. it is within the employer's control to achieve them), the liability should be reported at the lowest amount of the available alternatives. (Section 5)
- (d) Regulatory measures of liabilities to pay pensions should not replace measures derived from general accounting principles. (Paragraphs 6.7-6.19)
- (e) The objective of a current value measure of future payments of pension benefits is to reflect today's value of the future cash outflows expected to settle the liability when it falls due. This approach might be viewed as an 'entity-specific' measurement, because it aims to reflect not only the properties of the liability itself but also the relationship to its owner. Where this measure is derived from discounting future cash flows it should reflect:

The financial reporting of pensions

- (i) expected value of cash flows (entity's best estimates) that would be admitted under the proposals in Chapter 2
- (ii) current market discount rate to reflect the time value of money only, i.e. a risk-free rate.

(Paragraphs 6.20-6.41)

- (f) In theory the liability should also reflect a margin for risk, but there is concern that some risks (for example those relating to future changes in mortality) are 'unknowable' and therefore cannot be quantified. Accordingly, users are better served by disclosure about the sensitivities of the liability to changes in the assumptions that have been used in arriving at the best estimates. (Paragraphs 6.42-6.52)
- (g) It is inappropriate for an entity's liability for pensions to be reduced to reflect its credit risk. (Section 7)
- (h) Measurement of the liability should reflect expenses of administering the plan's accrued benefits. (Section 8)

9.2 An issue that arises is how *employees'* options regarding settlement should be viewed. One possibility is that the employer should report a liability that is based on the highest amount, until the employee elects to receive a lower amount. Another possibility is that the employer should report a liability that reflects the probability of different outcomes. (Paragraphs 5.15-5.17)

Measurement bases in IASB Framework

Historical cost

A1 Assets and liabilities that are measured using the historical cost basis are measured initially at their transaction cost. Thus liabilities that are incurred in exchange for assets or services are recorded at the amount of consideration received in the exchange.

A2 The carrying amounts of assets and liabilities that are measured initially at historical cost are usually changed in subsequent periods to reflect cost and income allocations, such as depreciation and interest methods. For example, some liabilities may be increased over time by the accrual of a rate of interest that is implicit in the transaction. The carrying amounts of such assets and liabilities are however still based on historical cost because the changes do not reflect price changes.

Current cost

A3 The current cost of a liability is described in the Framework as the undiscounted amount of cash that would be required to settle the obligation currently.

A4 The above definition might suggest that current cost could be viewed as a settlement amount, or exit value, because it is described as a price that would be paid to settle the liability at the measurement date. However, some would view current cost differently, as being the liability equivalent of the replacement cost of an asset (i.e. the amount that would have to be paid if the same or equivalent asset was acquired currently). The current cost of a liability could then be considered in terms of the amount of consideration that would currently be received to assume the liability.

A5 In more current thinking about different measurement attributes, the alternative view stated above corresponds more closely to what has been described in recent accounting literature as an 'entry price' for a liability.

Realisable (settlement) value

A6 The realisable (settlement) value of a liability is described in the Framework as the undiscounted amount of cash expected to be paid to satisfy the liabilities in the normal course of business.

A7 This definition is not particularly helpful to the consideration of long-term liabilities, since it may be viewed as the liability equivalent of net realisable value of assets, such as inventory, which refers to the net amount that an entity expects to realise from the sale of inventory in the ordinary course of business.

A8 The IASB's Glossary of Terms refers to net realisable value of an asset as an 'entity-specific value', which means the value is based on the cash flows that are expected by the entity that holds the asset. It

should also be noted that entity-specific value of a liability is described in the Glossary as the *present value* of cash flows an entity expects to incur when settling the liability.

Present value

A9 The Framework describes the present value of a liability as the present discounted value of the future net cash outflows that are expected to be required to settle the liability in the normal course of business. Like net realisable value, present value as defined is an entity-specific value. However, the definition of present value differs from the definition of net realisable value in that it is explicitly a discounted value rather than an undiscounted value.

A10 The reference to cash flows that are 'expected' to be paid 'in the normal course of business' to satisfy the liability suggests that present value could be viewed as the liability equivalent of the 'value in use' of an asset¹⁸.

A11 Present value is a technique that is used to reflect the time value of money in a measurement by discounting future cash flows at some rate of interest. It does not, however, define any particular measurement attribute of a liability. It could therefore be used in the measurement of a carrying amount that is based on historical cost or a current value. Therefore, present value is not a very useful measurement basis unless we know what the present value that results from the calculation is intended to represent. For example, without that knowledge, it is not possible to determine an appropriate rate of interest to be used to discount the cash flows.

¹⁸ Value in use of an asset is defined in IFRS 5 as the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

Requirements and proposals for measurement of liabilities under IFRS

Provisions

B1 IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, defines a provision as ‘a liability of uncertain timing or amount’.

B2 IAS 37 requires a provision to be measured at ‘the best estimate of the expenditure required to settle the present obligation at the balance sheet date’.

B3 The IASB is presently reviewing the measurement principle in IAS 37. The exposure draft of proposed amendments to IAS 37 (June 2005) proposes to clarify that:

(i) a provision should be measured, both initially and subsequently, at

“the amount that an entity would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date”

and

(ii) the measurement should reflect a current discount rate.

B4 The IASB is presently refining the proposal in (i) above, to clarify that, despite using two terms – ‘amount to settle’ and ‘amount to transfer’ – only one measurement attribute was intended, which is a ‘current settlement’ notion. However, the IASB has made it clear that IAS 37 does not require provisions to be reported at fair value.

Share-based payments

B5 For cash-settled share-based payment transactions¹⁹, IFRS 2, *Share-based Payment*, requires the goods or services acquired and the liability incurred to be measured at the fair value of the liability. The fair value of the liability should be remeasured at each balance sheet date until it is settled.

¹⁹ A share-based payment transaction in which an entity acquires goods or services by incurring a liability to pay cash or other assets to the supplier of those goods or services for amounts that are based on the price (or value) of the entity’s shares.

Financial liabilities

B6 A liability to pay retirement benefits has characteristics of a financial liability because it is a contractual obligation to pay cash to employees, former employees or their dependents.

B7 With exceptions, IAS 39, *Financial Instruments: Recognition and Measurement*, requires financial liabilities to be measured at amortised cost using the effective interest method:

- (a) the carrying amount of a liability is adjusted if an entity revises its estimates of cash flows, to reflect revised estimated cash flows
- (b) in contrast, the carrying amount of a liability is not adjusted to reflect changes in market rates of interest.

B8 Derivatives and financial liabilities held for trading are measured at fair value.

B9 The IASB's project update on financial instruments sets out long-term objectives agreed by the IASB and FASB boards to improve and converge their accounting standards on financial instruments. One of those objectives is to require that all financial instruments be measured at fair value with realised and unrealised gains and losses recognised in the period in which they occur.

Insurance contracts

B10 In its project to develop a new accounting standard for insurance contracts, the IASB has tentatively decided that the measurement attribute for all insurance liabilities should be the amount the insurer would have to pay if it transferred all its remaining contractual rights and obligations immediately to another entity. This amount is referred to in the Discussion Paper as 'current exit value'.

B11 Determining a 'current exit value' makes use of the following inputs:

- current unbiased probability-weighted estimates of future cash flows
- current market discount rates that adjust the estimated future cash flows for the time value of money
- explicit and unbiased estimate of the margin the market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin).

B12 The project reports note that measurement at current exit value is not intended to imply that an insurer can, will or should actually transfer a liability to a third party. However, the basis for choosing that measurement attribute is stated to be that it provides users with useful information that will help them make economic decisions. This is because *inter alia* it emphasises current estimates of cash flows

and the appropriate price for those cash flows and makes use of observable market inputs to the extent they exist.

B13 The Discussion Paper notes that the IASB is not yet in a position to determine whether the notions of current exit value and fair value are the same. That is because defining fair value is still work-in-progress in its project on fair value measurement. However, it notes that the IASB has not identified significant differences between them.

Illustrative example – credit risk

Entities A and B have similar creditworthiness.

- Entity A borrows cash of CU 100,000, repayable with interest of CU 34,000 in 5 years. The ‘risk-inclusive’ rate of interest is 6%.
- Entity B receives services in exchange for the promise of a lump sum cash payment of CU 134,000 in 5 years.
- The risk-free rate of interest for that term is 5%.
- The credit risk premium for both A and B increases to 2% after one year, i.e. a ‘risk-inclusive’ rate is now 7%. The risk-free rate of interest remains at 5%.

The accounting for A and B’s respective obligations under various possibilities for initial recognition and subsequent remeasurement – including or excluding credit risk from measurements – is illustrated in the following table.

	Year 0: include credit risk	Year 1: exclude change in credit risk	Year 1: include change in credit risk	Year 0: exclude credit risk	Year 1: exclude change in credit risk
Entity A					
Liability	100	106	102	105	110
Profit (loss)		(6)	(2)	(5)	(5)
Entity B					
Liability	100	106	102	105	110
Profit (loss)	(100)	(6)	(2)	(105)	(5)

APPENDIX D

Fair Value Discussion Paper

D1 In November 2006, the IASB issued a Discussion Paper 'Fair Value Measurements' which includes the text of SFAS 157 'Fair Value Measurements'. The purpose of the IASB's project is to establish a single source of guidance for all fair value measurements required by IFRSs. SFAS 157 defines fair value as:

"The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the balance sheet date."

D2 SFAS 157 emphasises that the objective of a fair value measurement is a *market-based* measurement, not an *entity-specific* measurement. The assumptions that underlie a fair value measurement in relation to liabilities include:

- (a) The transaction to transfer the liability occurs in the principal market for the liability (the market with the greatest volume and level of activity for the liability) or, in the absence of a principal market, the most advantageous market (the market in which the entity would transfer the liability to minimise the amount that would be paid). If there is a principal market, the price in that market should be used even if there is a more advantageous market.
- (b) The fair value of the liability should reflect the non-performance risk relating to that liability.
- (c) The liability is transferred to a market participant at the measurement date (the liability to the counterparty continues; it is not settled) and that the non-performance risk relating to the liability is the same before and after its transfer.
- (d) Inputs to valuation techniques are assumptions that market participants would use in pricing the liability, including assumptions about risk.
- (e) Valuation techniques should maximise the use of observable inputs and minimise the use of unobservable inputs.

D3 The IASB highlights in its discussion paper three specific differences between the definition of fair value in SFAS 157 and the definition in IFRSs:

- (a) The definition in SFAS 157 is explicitly an *exit (selling) price* – reflecting that the objective of a fair value measurement is to determine the price that would be received for an asset or paid to transfer a liability at the measurement date.

The IASB notes that a fair value measurement with an exit price objective is appropriate because it reflects current market-based expectations of flows of economic benefit into or out of the entity.

(b) The definition in SFAS 157 explicitly refers to market participants – the implication being that a fair value measurement should be based on the assumptions that market participants (rather than the entity) would use in pricing the asset or liability, regardless of the entity's intention or ability to sell the asset or transfer the liability at the measurement date.

(c) For liabilities, the definition of fair value in SFAS 157 rests on the notion that the liability is transferred to a market participant (the liability to the counterparty continues; it is not settled with the counterparty).

Therefore in a fair value measurement, any advantages or disadvantages that the entity holding a liability may have relative to the market that would make it more (or less) beneficial for the entity to settle the liability in the normal course of business would not be reflected in the measurement of the liability. Instead, if the entity could settle its liability more cheaply in the normal course of business, the gain from doing so would be reflected in profit or loss in later periods until settlement. In contrast, entity-specific measurements of liabilities (such as an entity-specific settlement amount or value in use) would reflect the entity's expectations of cash outflows.

Fair value hierarchy

D4 SFAS 157 establishes a three-level hierarchy that prioritises the inputs to valuation techniques used to measure fair value (valuation techniques are used to convert future cash flows to a single present amount (discounted)):

Level 1 inputs: Quoted prices in active markets for identical liabilities that the entity has the ability to access.

Level 2 inputs: Other inputs that are observable, either directly or indirectly, including:

- quoted prices for similar liabilities in active markets
- quoted prices for identical or similar liabilities in markets that are not active
- other observable inputs (such as interest rates)
- market-corroborated inputs (inputs that are derived principally from or corroborated by observable market data)

Level 3 inputs: Unobservable inputs that reflect the entity's own assumptions about the assumptions that market participants would use in pricing the liability (including assumptions about risk). Unobservable inputs, which might include the entity's own data, might be used in situations in which there is little, if any, market activity for the liability.

IAS 19 BC: discount rate

- 26 One of the most important issues in measuring defined benefit obligations is the selection of the criteria used to determine the discount rate. According to the old IAS 19, the discount rate assumed in determining the actuarial present value of promised retirement benefits reflected the long-term rates, or an approximation thereto, at which such obligations are expected to be settled. The Board rejected the use of such a rate because it is not relevant for an entity that does not contemplate settlement and it is an artificial construct, as there may be no market for settlement of such obligations.
- 27 Some believe that, for funded benefits, the discount rate should be the expected rate of return on the plan assets actually held by a plan, on the grounds that the return on plan assets represents faithfully the expected ultimate cash outflow (i.e. future contributions). The Board rejected this approach because the fact that a fund has chosen to invest in certain kinds of asset does not affect the nature or amount of the obligation. In particular, assets with a higher expected return carry more risk and an entity should not recognise a smaller liability merely because the plan has chosen to invest in riskier assets with a higher expected return. Therefore, the measurement of the obligation should be independent of the measurement of any plan assets actually held by a plan.
- 28 The most significant decision is whether the discount rate should be a risk-adjusted rate (one that attempts to capture the risks associated with the obligation). Some argue that the most appropriate risk-adjusted rate is given by the expected return on an appropriate portfolio of plan assets that would, over the long term, provide an effective hedge against such an obligation. An appropriate portfolio might include:
- (a) fixed-interest securities for obligations to former employees to the extent that the obligations are not linked, in form or in substance, to inflation;
 - (b) index-linked securities for index-linked obligations to former employees; and
 - (c) equity securities for benefit obligations towards current employees that are linked to final pay. This is based on the view that the long-term performance of equity securities is correlated with general salary progression in the economy as a whole and hence with the final-pay element of a benefit obligation.

It is important to note that the portfolio actually held need not necessarily be an appropriate portfolio in this sense. Indeed, in some countries, regulatory constraints may prevent plans from holding an appropriate portfolio. For example, in some countries, plans are required to hold a certain proportion of their assets in the form of fixed-interest securities. Furthermore, if an appropriate portfolio is a valid reference point, it is equally valid for both funded and unfunded plans.

Those who support using the interest rate on an appropriate portfolio as a risk-adjusted discount rate argue that:

- (a) portfolio theory suggests that the expected return on an asset (or the interest rate inherent in a liability) is related to the undiversifiable risk associated with that asset (or liability). Undiversifiable risk reflects not the variability of the returns (payments) in **absolute** terms but the **correlation** of the returns (or payments) with the returns on other assets. If cash inflows from a portfolio of assets react to changing economic conditions over the long term in the same way as the cash outflows of a defined benefit obligation, the undiversifiable risk of the obligation (and hence the appropriate discount rate) must be the same as that of the portfolio of assets;
- (b) an important aspect of the economic reality underlying final salary plans is the correlation between final salary and equity returns that arises because they both reflect the same long-term economic forces. Although the correlation is not perfect, it is sufficiently strong that ignoring it will lead to systematic overstatement of the liability. Also, ignoring this correlation will result in misleading volatility due to short-term fluctuations between the rate used to discount the obligation and the discount rate that is implicit in the fair value of the plan assets. These factors will deter entities from operating defined benefit plans and lead to switches from equities to fixed interest investments. Where defined benefit plans are largely funded by equities, this could have a serious impact on share prices. This switch will also increase the cost of pensions. There will be pressure on companies to remove the apparent (but non-existent) shortfall;
- (c) if an entity settled its obligation by purchasing an annuity, the insurance company would determine the annuity rates by looking to a portfolio of assets that provides cash inflows that substantially offset all the cash flows from the benefit obligation as those cash flows fall due. Therefore, the expected return on an appropriate portfolio measures the obligation at an amount that is close to its market value. In practice, it is not possible to settle a final pay obligation by buying annuities since no insurance company would insure a final pay decision that remained at the discretion of the person insured. However, evidence can be derived from the purchase/sale of businesses that include a final salary pension scheme. In this situation the vendor and purchaser would negotiate a price for the pension obligation by reference to its present value, discounted at the rate of return on an appropriate portfolio;
- (d) although investment risk is present even in a well-diversified portfolio of equity securities, any general decline in securities would, in the long term, be reflected in declining salaries. Since employees accepted that risk by agreeing to a final salary plan, the exclusion of that risk from the measurement of the obligation would introduce a systematic bias into the measurement; and

- (e) time-honoured funding practices in some countries use the expected return on an appropriate portfolio as the discount rate. Although funding considerations are distinct from accounting issues, the long history of this approach calls for careful scrutiny of any other proposed approach.

30 Those who oppose a risk-adjusted rate argue that:

- (a) it is incorrect to look at returns on assets in determining the discount rate for liabilities;
- (b) if a sufficiently strong correlation between asset returns and final pay actually existed, a market for final salary obligations would develop, yet this has not happened. Furthermore, where any such apparent correlation does exist, it is not clear whether the correlation results from shared characteristics of the portfolio and the obligations or from changes in the contractual pension promise;
- (c) the return on equity securities does not correlate with other risks associated with defined benefit plans, such as variability in mortality, timing of retirement, disability and adverse selection;
- (d) in order to evaluate a liability with uncertain cash flows, an entity would normally use a discount rate lower than the risk-free rate, yet the expected return on an appropriate portfolio is higher than the risk-free rate;
- (e) the assertion that final salary is strongly correlated with asset returns implies that final salary will tend to decrease if asset prices fall, yet experience shows that salaries tend not to decline;
- (f) the notion that equities are not risky in the long term, and the associated notion of long-term value, are based on the fallacious view that the market always bounces back after a crash. Shareholders do not get credit in the market for any additional long-term value if they sell their shares today. Even if some correlation exists over long periods, benefits must be paid as they become due. An entity that funds its obligations with equity securities runs the risk that equity prices may be down when benefits must be paid. Also, the hypothesis that the real return on equities is uncorrelated with inflation does not mean that equities offer a risk-free return, even in the long term; and
- (g) the expected long-term rate of return on an appropriate portfolio cannot be determined sufficiently objectively in practice to provide an adequate basis for an accounting standard. The practical difficulties include specifying the characteristics of the appropriate portfolio, selecting the time horizon for estimating returns on the portfolio and estimating those returns.

31 The Board has not identified clear evidence that the expected return on an appropriate portfolio of assets provides a relevant and reliable indication of the risks associated with a defined benefit obligation, or that such a rate can be determined with reasonable objectivity. Therefore, the Board decided that the discount rate should reflect the time value of money but

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should not attempt to capture those risks. Furthermore, the discount rate should not reflect the entity's own credit rating, as otherwise an entity with a lower credit rating would recognise a smaller liability. The rate that best achieves these objectives is the yield on high quality corporate bonds. In countries where there is no deep market in such bonds, the yield on government bonds should be used.

FRS 17, Appendix IV: discount rate

- 13 In the UK, actuaries have traditionally discounted the liabilities in a defined benefit scheme at the expected rate of return on the assets in the scheme (prudently estimated). IAS 19 (revised) and SFAS 87 require the use of a high quality corporate bond rate.
- 14 The Board believes that the discount rate should reflect the time value of money and the risk associated with the liability. The view put forward in the Discussion Paper published in 1998 was that such a rate could be determined by looking at the rate of return on matching assets. (If the assets exactly matched the liability they must have the same fair value and hence the discount rate appropriate for the liability must be the same as the rate of return on the asset.) Matching assets were expected to be:
 - (a) for pensions fixed in monetary terms, fixed rate government bonds;
 - (b) for index-linked pensions in payment and deferred pensions, index-linked government bonds;
 - (c) for final salary liabilities, a portfolio containing some element of equity investments.
- 15 However, later research conducted by the Faculty and Institute of Actuaries demonstrated from past data that the correlation between equities and salaries had not been close and that the best match for final salary liabilities was probably index-linked bonds.
- 16 Some argue that even if there is no close correlation between equity and salary growth, it is appropriate to use the expected return on equities as the discount rate if the scheme is invested therein because, over the long term, that return is relatively secure. However, the higher return expected on equities is a reward for the risk involved in equity investment. Unless the risk matches that associated with the liabilities, discounting the liabilities at the higher return anticipates the expected benefit of equity investment without recognising the risks involved. The higher return should instead be recognised as it is earned over the period the equities are held.
- 17 On the other hand, although index-linked bonds seem to have been a better match for final salary liabilities, they are not a perfect match and an index-linked bond discount rate would ignore some important aspects of a final salary pension liability, for example the uncertainty of the amounts ultimately to be paid out. The Board has therefore decided not to try to find matching assets but to build up the discount rate from its components. As noted above, it believes that, if possible, the discount rate should reflect:
 - (a) the time value of money (given by the rate of return on an investment regarded as being risk-free); and
 - (b) the risks associated with the liability because of the uncertainty surrounding the ultimate cash payments due.
- 18 The FRS requires the assumptions to reflect the best estimate of the ultimate cash flows. The

resulting liability is clearly subject to uncertainty - the ultimate cash flows are not contractually fixed and will depend on final salaries, length of retirement etc. The uncertainty of the future cash outflows might be expected to make the liability more onerous - most entities are risk-averse and would prefer to avoid the possibility that the cash flows might be more than expected.

- 19 However, in many defined benefit schemes, the employer has the option of preventing the cash flows being greater than expected and even of reducing the cash flows if necessary (e.g. if investment performance has been consistently poor for a long period). These options exist because the best estimate of the cash flows will include expected benefit increases likely to be granted by the employer such as (i) increases in pensions in payment and deferred pensions at above the minimum required by statute or the scheme rules and (ii) increases in benefits arising from salary increases for active members over and above the rate applicable if they left service (it is assumed that an employer would, over any substantial period, have to increase salaries by at least the indexing rate applied to deferred pensions). Although the employer expects to give these increases, they are not guaranteed. If necessary the employer could, in many cases, give lower than expected increases in benefits and give lower than expected salary increases. In extremis, the employer could even close the scheme down.
- 20 These options are a crucial factor in the operation of UK defined benefit schemes and the level of benefits that is given. Employers' willingness to provide the expected benefits is often based, at least partly, on the assumption that the liability can be funded in equities. The expectation is that a higher return on equities compared with that on less risky investments will make such promises affordable. The employer can bear the risk associated with the higher return because, if equities were to underperform for a long period, the options described above allow the employer to take action to mitigate the financial impact.
- 21 These options make the liability less onerous and can be reflected by using a discount rate higher than a risk-free rate. In principle, the premium over the risk-free rate should vary from scheme to scheme (and within schemes), reflecting the differing levels of discretion that exist for different scheme liabilities. However, assessing the appropriate premium is difficult and subjective. In the interests of objectivity and international harmonisation, the Board has therefore decided to adopt a standard discount rate: the rate of return on a high quality corporate bond, i.e. one rated at the level of AA or equivalent status. This includes a small premium above the risk-free rate, which can be regarded as reflecting the options open to the employer to limit the pension scheme liabilities.
- 22 Reflecting these options in the discount rate is not inconsistent with the proposal in paragraph 31 of the FRS that it is not appropriate to assume a reduction in benefits below those currently promised. It is not appropriate to assume that a curtailment of the scheme will take place in the future but it is appropriate to reflect the value of the *option* to make that curtailment.

Chapter 6: Measurement of assets held to pay benefits

1 Introduction

1.1 Chapter 3 discusses what assets and liabilities might be reported by each reporting entity that is involved in a pension plan when assets are set aside to provide security for promised benefits and funds for their payment. In some arrangements assets are held in a separate trust or similar entity; in other arrangements assets are held by the employing entity itself.

1.2 Conventional types of assets held in these arrangements are financial assets (including government securities, corporate bonds, equities, insurance contracts) and property interests. Less conventional (but increasingly used) types of assets include derivative contracts and interests in private equity and infrastructure.

1.3 Appendix A lists a variety of methods of measurement used in IFRS for the types of assets that might be expected to be held in arrangements for the funding of pension plans. The methods are mainly based on either historical cost or fair value. Moreover, different models exist in IFRS for reporting gains and losses in respect of changes in assets – for example, changes in fair values of some assets are required to be reported in profit and loss, others are required to be reported as changes in equity.

1.4 Accounting standards on pensions, however, distinguish assets held to fund liabilities to pay pensions from other similar assets held by an entity. IAS 19 does this by creating a separate class of asset – plan assets – which it requires to be measured at fair value. The requirements of IAS 19, SFAS 87 and FRS 17, together with their explanation, are set out in Appendix B.

1.5 Chapter 3 identifies four possibilities for reporting assets and liabilities in an employer's financial statements:

- (a) Show the underlying investments as assets (and show separately the liability to pay benefits) – when the entity has the obligation to pay benefits and assets are segregated to fund them but held within the reporting entity (see paragraph 2.27 of Chapter 3).
- (b) Show a right to reimbursement from a pension fund as an asset (and show separately the liability to pay benefits) – when the entity has a direct obligation to pay benefits and the assets that fund them are held by a separate entity (see paragraph 2.34 of Chapter 3).
- (c) Show a net liability or asset – when the entity has an obligation to support a trust that holds the assets and has the liability to pay benefits (see paragraph 2.39 of Chapter 3).
- (d) Show the underlying investments as assets in the employing entity's consolidated financial statements (and show separately the liability to pay benefits) – when the assets and the liability to

pay benefits are held by a separate entity which falls to be consolidated by the employing entity (see section 3 of Chapter 3).

1.6 In each of the circumstances set out above, the economic benefits from the underlying investments that are available to the employing entity are similar (subject to any restriction on recovering surplus assets when they are not held by the entity). In other words the economic effect is similar whether the assets are reported on a gross or net basis. This suggests that it might be presumed that a similar measurement method should be adopted in each case, whether or not a separate entity exists to hold the assets. Chapter 7 discusses further the measurement of employer interests when a net liability or asset is shown.

2 Providing decision-useful information

2.1 In accordance with the approach outlined in Chapter 1 of this paper, views on the measurement of assets have been informed *inter alia* by the objective of financial reporting as set out in the IASB's Framework, which is to provide decision-useful information about an entity's financial position, performance and changes in financial position.

2.2 Assets that are used to fund an entity's pension obligations are closely linked to the liabilities to pay benefits because they ultimately provide cash to settle the liabilities when they fall due. To evaluate the implications of such arrangements for an entity's cash flows and the risks arising, users need to understand how the assets and liabilities interrelate.

2.3 The most obvious illustration of a link between assets and liabilities is an arrangement in which the amount of benefits is determined by the value of a portfolio of assets in which contributions have been invested. Ultimately the accumulated assets will be used to provide funds for the benefits that will become payable. Unless the assets and the related liability are measured at the same amounts, accounting mismatches will arise and the financial statements will not reflect the underlying economics.

2.4 In other circumstances funds will be provided by the accumulated assets and, potentially, further contributions by the employer (and by the employees in so-called contributory arrangements). Some commentators have been concerned that the present accounting model fails to reflect how liabilities to pay benefits are expected to be met out of future cash flows from assets and contributions from employers and employees. Some argue that the model is not representative of future cash flows because it results in 'structural deficits' being shown on employers' balance sheets when funds are invested in assets that are expected to earn higher rates of return than the rate at which the liabilities are discounted – they claim that this is misleading when liabilities are considered to be adequately funded on a cash flow basis. More generally, some argue that the practice of representing assets at market values on a single date is a questionable way of representing the long-term values of assets that are held to provide funds for long-term liabilities. They claim that the model drives entities to take decisions about funding and investment

strategy (and perhaps benefits) that they would not otherwise have taken (and, it is sometimes suggested, they ought not to have taken).

2.5 Accounting for pension plans has limitations, of course, because any accounting measure can only provide a snapshot of the financial position at a point in time. Most would agree that single point values for assets and liabilities – no matter how they are measured – are not enough to tell a sufficiently full story about either item, or about the dynamic of the relationship between them. In addition, an accounting measure cannot itself provide the information that is necessary for a user to understand what the risks are from the promises that have been made or the assets that have been set aside to cover them. For example, a measure of an asset or liability at a certain date does not give any indication as to how it might change in the future. Disclosures are therefore necessary to support the accounting measures that are reported in the balance sheet (see Chapter 9).

3 Measurement characteristics

3.1 It is worth a reminder that this project is adopting a ‘back to basics’ approach to examining the fundamentals of the financial reporting of pensions; it is not seeking to re-examine the fundamentals of financial reporting. The measurement issue has therefore been approached by considering the following important characteristics, drawn from other accounting literature, that distinguish possible methods of measuring assets:

- (a) measurements based on current or historical information
- (b) market-based or entity-specific measurements

Measurements based on current or historical information

3.2 The discussion in Chapter 5 relating to measurement of liabilities to pay benefits supports a current value measure – which reflects the amount of the economic burden of the liability at the measurement date – based on up to date information about present and future economic conditions. Therefore, a method that measures the assets at a current value would be expected to rank more highly in terms of providing decision-useful information about the underlying economics than a method that measures them at an amount based on their historical cost. If the assets were measured on a basis that did not reflect economic conditions at the balance sheet date, an accounting mismatch in respect of the treatments of the assets and the related liabilities would arise which would make the entity’s financial position less understandable.

3.3 **In the light of the foregoing, it is concluded that reporting assets held to pay benefits at current values provides more useful information than reporting them at historical measures. This is consistent with the views presented on measuring liabilities to pay benefits.**

Market-based or entity-specific measures

3.4 If measurements based on historical information are discarded from further consideration, the principal candidates for current value measures are 'market-based' and 'entity-specific' measures.

Market-based measures

3.5 By *market-based* we mean that assets would be reported at market values at the balance sheet date, where market prices are available. Where market prices are not available (because, for example, the asset is not traded in an active market), a price at which the asset could be exchanged at the balance sheet date would be estimated using valuation techniques.

3.6 The definition of fair value in the FASB Statement 157 'Fair Value Measurements' (issued by the IASB as a discussion paper in November 2006) is a market-based measurement:

"Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the balance sheet date."

The IASB draws to attention the explicit reference in the proposed definition to market participants – the implication being that a fair value measurement should be based on the assumptions that market participants (rather than the entity) would use in pricing an asset, regardless of the entity's intention or ability to sell the asset at the measurement date.

3.7 SFAS 157 establishes a three-level hierarchy that prioritises the inputs to valuation techniques used to measure fair value. It gives the highest priority to quoted prices in active markets¹ for identical assets or liabilities (Level 1) – i.e. a quoted price should usually be used to measure fair value whenever available. The next priority is given to inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly (Level 2). The lowest priority is given to unobservable inputs (Level 3), which might be used in situations in which there is little, if any, market activity for an asset or its inputs.

Entity-specific measures

3.8 The philosophy behind an *entity-specific* value is that the value of many assets depends not only on the properties of the asset itself, but also on its relationship to its owner. Assets are more or less specialised, many contributing to the total cash flows of a business. Differences in the economic constraints and opportunities available to different entities are reflected in different perceptions of assets' values to their owners. For example, a particular entity may be able to exploit an asset in its business in a way that others cannot and so the asset may be worth more to the entity than the market price.

¹ An active market for an asset is a market in which transactions for the asset occur with sufficient frequency and volume to provide pricing information on an ongoing basis.

3.9 The principal example of an entity-specific measurement in accounting standards is *value-in-use*. Value in use is a measurement basis used in certain circumstances to determine whether items of property, plant and equipment and intangible assets are impaired and should be written down to their recoverable amounts. Value in use is defined in IAS 36 'Impairment of Assets', as "the present value of the future cash flows expected to be derived from an asset or cash-generating unit". It reflects the cash flows expected from continuing use of the asset and from its ultimate disposal.

Assets traded in active markets

3.10 Some believe that the requirement to use a market value for assets held to fund pension liabilities should be reconsidered and that there is a case to be made for an entity-specific measurement. This would apply to all such assets, including assets that are traded in active markets². The following arguments are made for this viewpoint:

- (a) Assets that are held to provide funds for retirement benefit obligations have a different use from similar assets that are held for trading or speculative purposes; an entity-specific value would reflect that different use when there was no current intention to sell.
- (b) If an entity believes an investment is worth holding for the long-term to provide funds for pension obligations and has the ability to do so, variability in market prices (which reflects among many other things short-term variations in the pricing of risks in the markets and hence in the risk premiums relating to different classes of assets) does not necessarily change the investment's fundamental value to the entity. This is particularly true when markets are temporarily dislocated at a financial reporting date. Stated differently, if an investment is held at least partly for the purpose of receiving income over a long period, short-term fluctuations in market prices do not affect the cash flows that are expected to be contributed by the employer to meet its long-term obligations and it is wrong to reflect them in the financial statements.
- (c) Measuring all assets at today's market prices fails to inform users about the expected benefits of different asset allocation and investment strategies. An argument that is sometimes raised against entity-specific measures is that an investment in bonds with a market price of CU 1,000 is worth the same, and should be reported at the same amount, as an investment in equities with a market price of CU 1,000. That argument is simplistic because the expected future cash flows or future prices are not the same. Studies have shown that equities have outperformed corporate bonds and government securities over long periods. There should be a way of reflecting expected future values when the related liabilities will mature.
- (d) Many plans have diversified out of quoted securities into alternative investments such as private equity. Valuations of such assets that are derived using valuation techniques tend to smooth out

² An active market has the same meaning as in other accounting standards dealing with measurement of financial instruments. For example, this would correspond to Level 1 inputs in the fair value hierarchy in SFAS 157 (see paragraph 3.7 above).

the short-term volatility that is reflected in quoted market prices, with the result that the present accounting requirements make them appear to be less, rather than more, risky than quoted securities.

- (e) The existing accounting standards have driven employers and trustees to make sub-optimal decisions in relation to funding long-term obligations by encouraging investments in assets with low returns to minimise accounting (or volatility) risk in the short-term.

3.11 Others note that, in general, the concept of an entity-specific value such as value in use is restricted in accounting standards to tangible or intangible assets that are used in a business, for example in measuring the recoverable amount of plant or equipment. They believe that assets that are held to provide funds for pensions do not yield economic benefits through use in the entity's business; instead their function is to hold a store of value. Under this view it is not relevant to distinguish similar assets held by different entities in the same way that specialised assets might be viewed in the context of specific owners, because the store of value cannot be worth more to the entity than market value.

3.12 Having said that, they note that the different viewpoints on market-based or entity-specific approaches essentially focus on the measurement of holdings of securities (especially equities) that are traded in active markets, the issue being whether they should be measured at market values or other estimate of current value. For other types of assets, valuation techniques (often based on discounted cash flows) are usually required to estimate current values under either approach. So the issue appears to be not so much about entity-specific and market-based measures *per se*, but rather whether a valuation technique can be used instead of a market value when the latter is available. They believe that the change from some previous accounting standards on pensions, which allowed assets to be measured at actuarial values, to the present accounting standards, which require such assets to be measured at market values, was well founded in the context of such assets for the following reasons:

- (a) When the asset in question is, for example, a small parcel of shares in a quoted company, a case for reflecting the current market value in the owner's financial statements is based on the existence of a market. Given a number of assumptions, it represents the amount that could be received from sale of the asset, and also the cost that the owner would incur in obtaining an equivalent asset. In addition it can be argued that it represents the market's assessment of the present value of future cash flows and, as it has been specified it is a small parcel, it does not confer significant rights to influence the investee, so these cash flows are the same irrespective of the owner.
- (b) It is not possible to know whether an asset's market value is above or below its 'fundamental value'. The market value might not be a good representation of the asset's value in the long-term, but it is the best estimate available at the time. Put another way, why should an entity be able to make a better assessment of value than the market? Furthermore, whilst it is acknowledged that markets are sometimes dislocated, it is considered that it is not possible to isolate the factors that might give rise to a different long-term value.

- (c) Most would agree that, for assets that do not have a market value, there are more ways of influencing the number that is reported in the balance sheet. But that does not justify allowing a valuation technique to be used when there is a market value; if there is a difference between the market value and the output from a valuation technique, it is possible that something is missing from the valuation model.
- (d) It cannot be plausibly contended that, at the balance sheet date, the entity would willingly and rationally either pay more than the market price to acquire an identical asset, nor would it willingly and rationally accept less than the market price. The asset's economic value cannot exceed the price at which it could be replaced.
- (e) The argument that an investment in bonds with a market value of CU 1,000 is worth the same as an investment in equities with a market value of CU 1,000 is correct in the context of financial statements drawn up at the measurement date. Any extra return that is expected to be earned from investing in riskier classes of assets is a reward for taking extra risk and should be accounted for in future periods. It would be inappropriate for an accounting model to recognise the expected *future* value of assets in the statements of an entity's *current* financial position and performance; that would be likely to reflect a financial position that a risk-seeking strategy for investment is more valuable than a risk-averse strategy. When a decision is made to invest in bonds or equities to provide funds to meet a liability, it is not possible to say whether one is inherently more valuable than the other.³
- (f) An accounting model that might require an entity to report an increase in its net assets by changing its investment strategy by, say, switching from bonds to equities is flawed – no value has (yet) been added by changing the asset allocation. A problem with the argument for a higher value than market value is that it would appear that an entity could report an immediate gain by increasing leverage – for example, if it borrowed for investment, it would report an additional asset if it expected to earn a higher return than the rate at which it had borrowed. The entity's own perception of the value of its investment strategy should be communicated by disclosure not recognition.
- (g) Investing in volatile assets to provide funds for long-term liabilities is a volatile business proposition, so it is not surprising that the accounting numbers might reflect that volatility. However, the basis for reporting the financial position at a point in time does not imply that it is or is not rational for employers and trustees to take investment decisions about funding long-term obligations that do not seek to minimise accounting risk.

³ Some claim that holding equities for longer periods increases rather than reduces risk because there is more chance of experiencing a disaster over a long period; they illustrate this with the higher cost of insuring against the risk of earning less than a risk-free rate of interest.

3.13 In the light of the foregoing discussion, this paper advances the view that the present requirement in pensions accounting standards that assets traded in active markets are measured at market values is well founded.

Large holdings⁴

3.14 Some are concerned about market prices being effectively marginal prices based on relatively small quantities of securities and not necessarily on the total quantity of securities held by a particular plan, if the plan has a large holding. For example, the 'Normal Market Size' (NMS), as defined by the London Stock Exchange, is the percentage of an individual company's stock for which a market maker is obliged to provide a quote. NMS is normally only 2.5% of the total volume of shares for the company in question and market makers are not obliged to provide a quote for any transaction of a size in excess of NMS.

3.15 The question arises, therefore, if a large holding of a security is being measured, whether the market price of an individual security multiplied by the number of shares provides the appropriate measurement, or whether that value should be adjusted to reflect the illiquidity of the large position.

3.16 This issue is not specific to pension plans, however. It applies to any large holdings that are reported in financial statements at a market-based measure. It is therefore beyond the scope of this paper to address it, other than to highlight it as a matter that is currently under debate (by noting below the position taken in the aforementioned IASB Discussion Paper 'Fair Value Measurement' and SFAS 157), because the view has been taken that there are no special reasons why the financial reporting requirements for pension plan assets should differ in this respect from the financial reporting requirements that apply to financial assets generally.

3.17 The Discussion Paper 'Fair Value Measurement' (which incorporates SFAS 157) proposes that if an entity has a large holding in an asset that is traded in an active market, no adjustment is made to the quoted market price because of the size of the position relative to trading volume (blockage factor) – even if the market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price. The IASB observes that this treatment is similar to the guidance in its standards on financial instruments, noting that the illiquidity of an individual instrument is not affected by the size of a position held by an entity."⁵

3.18 The issue relates to whether the unit of account is (a) the individual security or (b) a block of securities. Insight into the FASB's reasoning for concluding that the unit of account is the individual security is given in the following extract from the Basis for Conclusions to SFAS 157 (paragraph C79):

⁴ This paper does not address situations in which an asset is a shareholding in another entity that provides a controlling interest.

⁵ The IASB asked respondents to its discussion paper for their views on this issue.

“In reaching that decision, the majority of the Board affirmed its conclusions relating to the prohibition on the use of blockage factors in other FASB Statements. In particular, the Board emphasized that when a quoted price in an active market for a security is available, that price should be used to measure fair value without regard to an entity’s intent to transact at that price. Basing the fair value on the quoted price results in comparable reporting. Adjusting the price for the size of the position introduces management intent (to trade in blocks) into the measurement, reducing comparability. Following the reasoning used in Statement 107, the quoted price provides useful information because investors regularly rely on quoted prices for decision making. Also, the decision to exchange a large position in a single transaction at a price lower than the price that would be available if the position were to be exchanged in multiple transactions (in smaller quantities) is a decision whose consequences should be reported when that decision is executed. Until that transaction occurs, the entity that holds the block has the ability to effect the transaction either in the block market or in another market (the principal or more advantageous market for the individual trading unit).”

Investment strategy

3.19 Arguments for an entity-specific measurement call into question how the value to the entity of the investment strategy it is pursuing to meet its obligations should be reported to users.

3.20 Establishing a strategy requires an assessment of future investment returns on assets held to meet the obligations and the ability of the employer to make further contributions if they are required. The strength of the employer’s covenant may affect decision-makers’ views of an appropriate risk profile of the assets. Users are interested in the employer’s ability to continue to meet its obligations as they fall due, out of resources currently set aside and resources potentially available.

3.21 Some argue that the role played by the investment strategy in meeting the obligation should be reflected as some kind of asset in order to show a balanced view of the assets and liabilities. This asset would represent a value placed on the future cash flows from the investments that is not reflected in the current market value and could perhaps be shown separately as an addition to (or possibly in some circumstances a subtraction from) the market value.

3.22 Most contributors to this paper take the view, for the reason given in paragraph 3.12(f) above, that the role of investment strategy in meeting obligations to pay benefits requires explanation (rather than recognition) in financial statements (see Chapter 9).

3.23 This paper advances the view that the role of investment strategy in meeting obligations to pay benefits requires explanation (rather than recognition) in financial statements.

Assets not traded in active markets

3.24 The above discussion has largely related to the existence of an active market for the types of assets under consideration. This raises questions about the treatment of alternative investments that are not

traded in active markets with quoted prices, such as properties and unlisted equity investments.

3.25 The discussion earlier in this Chapter about the relevance of market-based and entity-specific measures is also applicable to assets not traded in active markets, and a similar conclusion might be drawn to that in paragraph 3.11 that the types of assets under consideration cannot be worth more to the entity than values at which they could be exchanged.

3.26 The discussion then turns to the relevance of alternative methods of measuring such assets. Some consider that there should be fallback to the treatment of similar assets in other IFRS, rather than a different set of requirements for assets held to provide funds for pensions. For example:

- applying IAS 40 'Investment Property' would allow property interests to be reported under a fair value model or a cost model;
- applying IAS 39 'Financial Instruments: Recognition and Measurement' would suggest that a cost model should be used to measure investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured.

3.27 IAS 19 does not make an exception to a fair value measurement principle for plan assets. Also, earlier in this Chapter, it has been proposed that reporting assets held to pay benefits at current values provides more useful information than historical measures (see paragraph 3.3). Under this view, a cost model would result in an accounting mismatch in respect of the treatments of assets and related liabilities, presenting a misleading view of the net position.

3.28 Moreover, it seems reasonable to presume in setting financial reporting requirements that if assets are being held to provide pensions and security of pensions, those responsible should have some idea of their value on an ongoing basis, and that there is some methodology available for estimating their value, otherwise questions would be raised about accountability and governance. This paper therefore supports the position that there is a stronger case for requiring that assets held to pay pensions should be reported at current values than necessarily would apply to similar assets held for other purposes – for example, the case for a concession such as that in IAS 39 in respect of unquoted equities seems less strong in the case of pension plans.

3.29 There is guidance in other accounting standards on valuation techniques for estimating fair values of assets that are not traded in active markets. For example, IAS 40 states that the fair value of investment property shall reflect market conditions at the balance sheet date and describes valuation techniques ranging from comparisons with current values of similar properties to discounted cash flow projections using discount rates that reflect current market assessments of the uncertainty in the amount and timing of the cash flows. Similarly, IAS 39 describes a range of valuation techniques for estimating the fair value of financial instruments in the absence of an active market, which include reference to current fair values of similar instruments, discounted cash flow analysis and option pricing models. Since the objective of using such techniques is to estimate a current value, and they are intended to be consistent with a market-

based approach for measuring assets that are traded in active markets, such techniques should also be appropriate for measuring assets held to fund pension liabilities. It is important that financial statements include appropriate disclosures about the valuation techniques, because valuations can be sensitive to the assumptions that have been used.

3.30 Some of the issues touched on above are issues that should concern the various industries in which assets of pension plans are now investing, because they would have to respond by delivering relevant information about values to those who are accountable for such assets.

3.31 In the light of the foregoing discussion, this paper advances the view that:

When an asset is not traded in an active market, a current value should be estimated using a valuation technique in accordance with the guidance in other accounting standards.

4 Summary

4.1 This Chapter advances the following views on the measurement of assets held to pay benefits:

- (a) Reporting assets held to pay benefits at current values provides more useful information than reporting them at historical measures. This is consistent with the views presented on measuring liabilities to pay benefits. (Paragraphs 3.2-3.3)
- (b) The present requirement in pensions accounting standards that assets traded in active markets are measured at market values is well founded. (Paragraphs 3.10-3.13)
- (c) The role of investment strategy in meeting obligations to pay benefits requires explanation (rather than recognition) in financial statements. (Paragraphs 3.19-3.23)
- (d) When an asset is not traded in an active market, a current value should be estimated using a valuation technique in accordance with the guidance in other accounting standards. (Paragraphs 3.24-3.31)

Requirements for measurement of assets under IFRS (except pensions)

Asset	Measurement method
Financial assets: held for trading (including derivatives)	Fair value [IAS 39]
Financial assets: held-to-maturity investments	Amortised cost using the effective interest method [IAS 39]
Financial assets: loans and receivables (not quoted in an active market)	Amortised cost using the effective interest method [IAS 39]
Financial assets: available-for-sale	Fair value [IAS 39]
Financial assets designated at fair value through profit or loss ⁶	Fair value [IAS 39]
Unquoted equity instruments whose fair value cannot be reliably measured	Cost [IAS 39]
Investment property	Fair value model or cost model [IAS 40]
Property, plant and equipment	Cost model or revaluation model (based on current fair value) [IAS 16] Measurement not to exceed recoverable amount (i.e. higher of fair value less costs to sell and value in use) [IAS 36]

⁶ An entity is permitted to designate a financial asset at fair value through profit or loss when it results in more relevant information than other bases, including when it eliminates or significantly reduces an 'accounting mismatch' that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.

Accounting standards on pensions

B1 Accounting standards on retirement benefits distinguish assets held to fund liabilities to pay pensions from other similar assets held by an entity. For example:

- (a) IAS 19 does this by creating a separate class of asset – plan assets. Plan assets are assets that exist solely to pay or fund benefits and are completely ring-fenced from other claims on the entity⁷. Plan assets – measured at fair value – are deducted from the present value of defined benefit obligations in arriving at the measurement of a net liability (or asset). In no circumstances are ‘plan assets’ as defined in IAS 19 reported separately as assets of the employing entity.
- (b) SFAS 87 (as amended by SFAS 158) requires the funded status of a benefit plan – measured as the difference between the fair value of plan assets (with limited exceptions) and the benefit obligation – to be recognised in the employer’s statement of financial position.
- (c) The UK standard FRS 17 requires assets in a defined benefit scheme to be measured at their fair value at the balance sheet date for the purpose of measuring the surplus or deficit to be recognised in the employer’s balance sheet.
- (d) The international accounting standard concerning financial reporting by retirement benefit plans, IAS 26 ‘Accounting and Reporting by Retirement Benefit Plans’, requires investment assets to be carried at fair value (which in the case of marketable securities is market value) unless an estimate of fair value is not possible.⁸

⁷ Assets held by a long-term employee benefit fund are defined in IAS 19 as assets (other than non-transferable financial instruments issued by the reporting entity) that:

- (a) are held by an entity (a fund) that is legally separate from the reporting entity and exists solely to pay or fund employee benefits; and
- (b) are available to be used only to pay or fund employee benefits, are not available to the reporting entity’s own creditors (even in bankruptcy), and cannot be returned to the reporting entity, unless either:
 - (i) the remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting entity; or
 - (ii) the assets are returned to the reporting entity to reimburse it for employee benefits already paid.

⁸ However, IAS 26 permits securities that have a fixed redemption value and that have been acquired to match the obligations of the plan, or specific parts thereof, to be measured on an amortised cost basis. IAS 19 does not allow that alternative measurement basis to be used.

B2 The former IASC put forward the following arguments for using market values for plan assets during the development of a new IAS 19:⁹

- (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.

B3 SFAS 87 explains the requirement to use fair value as follows:¹⁰

“The Board concluded that plan investments should be measured at fair value.....Fair value provides the most relevant information that can be provided for assessing both the plan’s ability to pay benefits as they come due without further contributions from the employer and the future contributions necessary to provide for benefits already promised to employees...”

B4 The UK ASB explains the use of fair value in FRS 17 as follows:

“...the Board did not believe that there were sufficient reasons for the UK to differ from the rest of the world by measuring scheme assets at an actuarial value that did not equal fair value. In addition, and perhaps more importantly, it was clear that substantial changes were taking place within the actuarial profession relating to the traditional actuarial methodologies for measuring assets in a pension scheme. Of the actuaries responding to the 1995 Discussion Paper, all but one supported the use of actuarial valuations. Of the actuaries responding to the 1998 Discussion Paper, all but one supported the use of market values. Given this, and the advantages of market values in terms of objectivity and understandability, the Board believes there is no credible alternative to their use.”

⁹ IASC Issues Paper ‘Retirement benefits and other employee benefit costs’ August 1995. The IASC subsequently decided that plan assets should be measured at fair value.

¹⁰ SFAS 87, paragraph 117.

Chapter 7: Measurement of employer interests in assets and liabilities of trusts and similar entities

1 Introduction

1.1 This Chapter discusses the measurement of assets and liabilities shown in the sponsoring employer's financial statements when a separate trust or similar entity¹ is established to hold assets to pay benefits.

1.2 Chapter 3 identifies three possibilities for reporting assets and liabilities in an employer's financial statements when assets are held by an employer-sponsored trust:

- (a) Consolidate the trust in the employer's *consolidated* financial statements – when the assets and the liability to pay benefits are held by a separate trust which falls to be consolidated by the employer (see section 3 of Chapter 3).
- (b) Show a right to reimbursement from a trust as an asset (and show separately the liability to pay benefits) – when the employer has a direct obligation to pay benefits (see paragraph 2.34 of Chapter 3).
- (c) Show a net liability or asset – when the trust has the liability to pay benefits and the employer has an obligation to support the trust (see paragraph 2.39 of Chapter 3).

Each of the above is considered in the following sections.

2 Consolidation of a trust

2.1 If a trust falls to be consolidated in the sponsoring employer's consolidated financial statements, the discussion in Chapter 6 regarding the measurement of assets held to pay benefits and Chapter 5 regarding the measurement of liabilities to pay benefits is relevant to the measurement of assets and liabilities shown in the employer's consolidated balance sheet because they are measured directly.

3 Recognition of a right to reimbursement from the trust

3.1 The recognition of a right to reimbursement might arise when the employer has a direct obligation to pay benefits and, separately, a right to be reimbursed from the trust.

3.2 The economic benefits that are available from the right to be reimbursed from the trust are similar to the economic benefits that would be available if the assets were held directly by the employer. Therefore, it seems reasonable to take the view that the measurements should be consistent, i.e. the right to reimbursement should be measured on the same basis as the underlying assets held by the trust.

¹ For brevity, this Chapter uses the term 'trust'.

3.3 IFRIC 5 'Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds' adopts a similar position; measurement of the right to receive reimbursement from a fund is based on the contributor's share of the fair value of the net assets of the fund attributable to contributors.

3.4 If the amount of assets held by the trust exceeds the amount of the liability to pay benefits, the amount of the right to reimbursement may need to be reduced if there is any restriction (by law or contract) on the employer recovering surplus assets (as measured for the purpose of financial statement reporting) from the trust.

4 Recognition of a net liability or asset

4.1 In Chapter 3 it is argued that where it is determined that a sponsoring employer does not have control of a trust, the trust should not be consolidated. Instead the employer's financial statements should present a net asset or liability that reflects its right to benefit from a surplus or its obligation to contribute to a deficit. The rationale for a 'net' presentation is that, from the employer's perspective, its liability to provide pension benefits is partially settled by making contributions to the trust. Any remaining exposure arises only to the extent that the assets of the trust are insufficient to meet the liabilities to pay benefits and the employer has an obligation to make good any deficit. In that model the assets held by the trust and the liability to pay benefits are assets and liabilities of the trust, not the employer.

4.2 Under present accounting standards on pensions, the employer's net exposure is measured as the difference between the two underlying gross amounts, each being measured as if they were assets and liabilities of the employer. That treatment reflects the view that the entity's net economic exposure is similar, whether its rights and obligations are reported on a gross or net basis – in the latter case, the employer remains exposed to movements in the gross amounts of assets and liabilities.

View that employer's net interest should be measured by reference to its obligation to pay contributions

4.3 Some argue that the existing model of 'quasi-consolidation' does not properly reflect the nature of the employer's interest in some arrangements in which assets are ring-fenced in separate trusts, with independent responsibilities, that are beyond the control of the employer. It is argued that, if the underlying assets and liabilities belong to the trust and the trust is not consolidated because it is not controlled by the employer, the employer's (net) interest in the trust could be measured directly – on the basis of cash flows expected to be contributed from the employer to the trust – rather than being measured as if the assets and liabilities of the trust belonged to the employer.

4.4 On this view, the employer's interest is a net liability or asset that reflects a long-term measure of the cash inflows and outflows of the trust. Cash inflows include cash generated from the assets of the trust and contributions from employees; cash outflows include the payment of benefits. Under such an approach, the employer would recognise a liability when there is a shortfall in expected cash flows of the trust that has to be met by the employer, i.e. when the cash flows from the assets of the trust are not

expected to be sufficient to meet its liabilities. Measurement of the liability would then reflect the employer's obligation to pay contributions to the trust in order that the trust can meet its liabilities when they fall due. Similarly, the employer would recognise an asset when there is a surplus in expected cash flows of the trust and the employer had the right to benefit from that surplus.

4.5 To take a very simple example for illustration, consider a situation where the underlying assets and liabilities would be measured at 80 and 100 respectively under the principles set out in Chapters 5 and 6 if they were held directly by the employer, leaving a net deficit of 20. The employer's obligation to the trust (in respect of benefits earned for past service) is expected to be met by seven annual contribution payments of 3, after taking into account the expected returns on investments. The present value of the expected payments is, say, 15. Why should the employer not report a net liability of 15 (based on its expected future contribution of 21) instead of 20?

4.6 The arguments for such an approach to some extent mirror the arguments for allowing an entity-specific measure (rather than a market-based measure) of the assets (see paragraph 3.11 of Chapter 6). The thrust of the concerns is that, for traditional defined benefit plans in particular, the accounting model fails to recognise how liabilities to pay benefits are expected to be met out of future cash flows from assets and contributions from employers. Some point to 'structural deficits' shown on employers' balance sheets when funds are invested in assets that are expected to earn higher rates of return than the rate at which the liabilities are discounted and claim that this is misleading when a scheme that is considered to be adequately funded on a cash flow basis.

View that employer's net interest should be measured as the difference between the underlying assets held and liabilities to pay benefits

4.7 Others point out that the approach in paragraph 4.5 implicitly places a different value on the assets or the liabilities than if they were measured directly under the principles set out in Chapters 5 and 6, because there is an assumption about the level of future investment returns on the assets that will be available to meet the benefit cash outflows. In their view that is wrong, because it is like saying, if someone has a long-term liability that is worth 100 and sets aside assets of 80 which are expected to grow to meet the liability when it falls due, then either the assets should be written up to 100 or the liability should be written down to 80.

4.8 A crucial consideration is that the above approach fails to capture an important element of the employer's obligation to the trust. That is the obligation to pay more into the trust if the trust's assets do not perform as expected and are insufficient to meet its liabilities. In other words, seven payments of 3 might not be enough. If there is in effect an additional constructive (or 'stand-ready') obligation provided by the employer, it is a present obligation that ought to be reflected in the net liability that is reported in the employer's financial statements. Furthermore, if the trust's assets include risky investments that are expected to produce higher returns to finance part of the deficit, the value of that additional obligation (i.e. reflecting the risk that the assets will not perform as expected) could be significant.

The financial reporting of pensions

4.9 The following table summarises the advocated approach to measurement of liabilities and of assets held in various scenarios for funding:

- the first is when there are no separate assets;
- the second is when separate assets are held by the employer;
- the third is when separate assets are held by a separate trust, but the employer has a direct obligation to pay benefits;
- the fourth is when separate assets are held by a separate trust, the trust has the liability to pay benefits and the employer has an obligation to support the trust.

	Who has liability to pay benefits?	Who holds assets?	Measurement of liability	Measurement of assets
1	Employer	None	Settlement amount	N/A
2	Employer	Employer	Settlement amount	Current value
3	Employer	Trust (employer has right to reimbursement)	Settlement amount	Current value
4	Trust	Trust	Settlement amount of liability less current value of assets	

4.10 The following economic similarities and differences might be suggested:

- The liability in scenario 2 is similar to that in scenario 1 except for credit risk.²
- The liability in scenario 3 is similar to that in scenario 2 except for credit risk (the beneficiaries are presumably better off in scenario 3 because they are better protected from the risk that

² Views on reflecting credit risk in the measurement of liabilities are discussed in Chapter 5.

promised pensions will not be paid). The economic benefits from the assets that accrue to the employer in scenario 3 are similar to scenario 2.

- In scenario 4, the employer has an obligation to fund any shortfall should the assets held by the trust be insufficient to settle the liability to pay benefits. It is suggested that no additional economic value is created compared to scenario 3 by using that vehicle; the employer has similar economic exposures that arise from the underlying assets and liabilities of the trust including, where applicable, mortality, inflation and investment risks. The value of the employer's net obligation in scenarios 3 and 4 (after deducting the value of the assets held by the trusts) appear therefore to be similar.

4.11 In the light of the foregoing discussion, this paper concludes that:

If the contractual arrangements result in a 'net' asset or liability being representative of the employer's rights and obligations, the measurement of the net amount should be based on the difference between the amounts at which the assets and liabilities would be measured if they were measured directly, subject to reflecting the effect of any restrictions on the assets.

5 Summary

5.1 This Chapter discusses the measurement of assets and liabilities shown in the sponsoring employer's financial statements when a separate trust or similar entity is established to hold assets to pay benefits. It concludes that:

- If the employer has a direct obligation to pay benefits and a right to be reimbursed by a trust, its right to reimbursement should be measured on the same basis as the underlying assets held by the trust. (Section 3)
- If the contractual arrangements result in a 'net' asset or liability being representative of the employer's rights and obligations, the measurement of the net amount should be based on the difference between the amounts at which the assets and liabilities would be measured if they were measured directly, subject to reflecting the effect of any restrictions on the assets. (Section 4)

Chapter 8: Presentation in the financial statements

1 Introduction

1.1 This Chapter considers how liabilities to pay pension benefits and assets held to pay them and the changes in these should be presented in financial statements.

1.2 In developing this Chapter of the discussion paper consideration was given as to whether (in view of the IASB and FASB ongoing project) now was an appropriate time to consider how amounts related to pensions might be presented within the financial statements, that is deferring the discussion of presentation until completion of the IASB project. However, it was considered that such an approach would leave the project incomplete, and that many might find it difficult to comment on proposals for the recognition and measurement of assets and liabilities without some indication of how they, and changes in them, might be presented.

1.3 It was therefore concluded that consideration should be given as to how to present amounts related to pensions within the structure set out in IAS 1 'Presentation of Financial Statements'.

2 Assumed model for presentation of financial statements

2.1 In order to consider how to present amounts related to pensions in the financial statements it is necessary to decide on the framework for the presentation of financial statements. The IASB and the FASB are currently undertaking a project which is reconsidering the presentation of information in financial statements.

2.2 As part of that project the IASB has recently issued a revised IAS 1. The publication of IAS 1 represents the outcome from phase A of the joint project. Phase A of the project addresses the statements that constitute a complete set of financial statements and the periods for which they are required to be presented.

2.3 The objective of the project is to develop requirements for the presentation of information in financial statements in ways that will improve the ability of investors, creditors, and other financial statements users to:

- (1) understand an entity's present and past financial position;
- (2) understand the past operating, financing, and other activities that caused an entity's financial position to change and the components of those changes; and
- (3) use that financial statement information (along with information from other sources) to assess the amounts, timing, and uncertainty of an entity's future cash flows.

The financial reporting of pensions

2.4 IAS 1 (paragraph 10) states that a complete set of financial statements comprises:

- (a) a statement of financial position as at the end of the period;
- (b) a statement of comprehensive income for the period;
- (c) a statement of changes in equity in the period;
- (d) a statement of cash flows for the period;
- (e) notes, comprising a summary of significant accounting policies and other explanatory information; and
- (f) a statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of an item in its financial statements, or when it reclassifies an item in its financial statements.

2.5 Prior to considering how to present amounts related to pensions in the financial statements a review of the structure of the statement of comprehensive income might be useful. IAS 1 (paragraph 81) provides :

An entity shall present all items of income and expense recognised in a period:

- (a) in a single statement of comprehensive income; or
- (b) in two statements: a statement displaying components of profit or loss (income statement) and a second statement beginning with profit or loss and displaying components of other comprehensive income (statement of comprehensive income).

2.6 In addition, paragraph 82 of IAS 1 provides a list of items to be included and notes that the statement of comprehensive income shall include a line item of finance costs.

2.7 In considering how to present amounts related to pensions in the financial statements for the purposes of this discussion paper it was decided that the structure and content as set out in IAS 1 should be used. This is because IAS 1 (as issued September 2007) represents the decisions already reached by the IASB in phase 1 of its project.

2.8 One of the issues that the IASB and FASB are considering as part of phase B of the presentation of financial statements project is the separation of an entity's financing activities from its business and other activities. The IASB and FASB have tentatively decided that financial statements should present information in a manner that (amongst other things) separates an entity's financing activities from its business and other activities and further separates financing activities into transactions with owners in their capacity as owners and all other financing activities.

2.9 Although the IASB and FASB are considering the distinction between business and financing activities, current accounting standards (including IAS 1) do not make such a distinction. This makes the task of discussing how to present amounts related to pensions within the statement of comprehensive income difficult. To render discussion easier in this Chapter we have assumed that financial performance will be reported in a manner that has separate components for:

- Operating activities;
- Financing; and
- Other financial performance

2.10 'Operating profit' is not currently defined in IFRS, and this paper makes no attempt to offer a definition, as the general sense is sufficient.

2.11 An appendix to this Chapter briefly sets out an alternative approach to the reporting of returns on assets and interest expense. This could not be considered in the body of this paper as it is fundamentally inconsistent with IAS 1.

3 Should changes in pension assets and liabilities be disaggregated?

3.1 Existing financial reporting standards vary on how the pension cost should be presented in the statement of comprehensive income. IAS 19 notes that the standard does not specify whether an entity should present current service cost, interest cost and the expected return on assets as components of a single item of income or expense on the face of the profit or loss account. SFAS 87 includes in the net periodic pension cost, the service cost, interest cost, return on assets and actuarial gains and losses, as one amount. It is, however, noted in the Basis for Conclusions to SFAS 87 that understanding of pension accounting is facilitated by considering the components of net periodic pension cost separately.

3.2 In contrast to SFAS 87, FRS 17 specifies the financial reporting of individual amounts arising from the changes in assets and liabilities should be presented. It distinguishes the following:

The financial reporting of pensions

Component	Represents
Current service cost	The increase in the present value of liabilities for pensions expected to arise from employee service in the current period.
Interest cost	The expected increase during the period in the present value of the liabilities for pensions because the benefits are one period closer to settlement.
Actuarial gains and losses	Changes in actuarial deficits or surpluses that arise because: (a) events have not coincided with the actuarial assumptions made for the last valuation (experience gains and losses) or (b) the actuarial assumptions have changed.
Expected return on assets	The average rate of return, including both income and changes in fair value, but net of scheme expenses expected over the remaining life of the related obligation on the actual assets held by the scheme.
Non-periodic pension costs	Non-periodic costs arise from settlement, curtailments or changes in the benefits provided by the pension plan.

3.3 The differing approaches of current financial reporting standards suggest that the first question to consider is whether presentation of the individual components that make up the total movement in liabilities to pay pensions and assets held to fund those liabilities (referred to as 'separate presentation') provides more useful information to users of financial statements than that of presenting a single amount for the pension cost ('net presentation').

3.4 Previous Chapters have suggested that there are circumstances in which an employer's balance sheet would show as separate items a liability (for example, to pay pensions) and assets (investments held to provide those benefits). This might be the case either in an employer's individual financial statements or where a separate trust is consolidated. In such cases, it would seem natural that changes in the assets and liabilities would be shown separately and not aggregated into a single net number. However, it has also been noted that in some circumstances, which probably arise quite commonly in practice, an employer's balance sheet will only show a 'net' number as it has a single asset or liability representing its interest in another entity such as a trust.

3.5 Where only a single amount is presented in the balance sheet a net presentation of changes in that amount might be favoured, especially as that amount is stated at a current value. This would be consistent with a view that any analysis of the change into components is arbitrary and therefore of limited value. However there are other items in the balance sheet which are presented as a single amount, but changes are presented separately; for example debtors are generally presented net of provisions whilst provisions against debtors may be recharged to operating costs and interest charged to

debtors may be shown as part of financing income although the debtors are represented as a single number on the balance sheet.

3.6 An advantage of separate presentation is that it improves comparability between two entities. It allows, for example, a distinction to be drawn between the cost of benefits and how those benefits are financed - that is a distinction can be drawn (at least) between operating and financing amounts.

3.7 For example the service cost may be seen as representing part of the total employment cost for the period, on the view that employees services have been obtained in exchange for salaries and other benefits of which the promise of pension benefits is a part. Unless a distinction is drawn either the current employment costs for the period are either understated (by omitting the value of pension promises made in the year) or overstated (by including interest expense). Meaningful comparison between entities is therefore enhanced by making the distinction.

3.8 Another reason for favouring separate presentation is that the changes in the assets and liabilities arise from different drivers and so have different predictive value. The interest cost is a function of the discount rate used and the size of the liability: in contrast the service cost for pensions is often a function of other employment costs and is affected by numbers of staff employed and changes in salary costs, which in turn are affected by inflation rates and other factors. Separate presentation enhances the ability of users to make predictions because their predictions can reflect their assessment of the possible changes in the underlying drivers.

3.9 As noted at the start of this Chapter, one of the objectives of the IASB and FASB presentation of financial statements project is to improve users' ability to understand past operating and financing decisions. Developing this objective suggests that if users are to understand the changes in assets and liabilities for pensions, a distinction needs to be drawn in the information presented regarding how the changes in assets and liabilities are related to operating and how they are related to financing decisions. Under this presentation elements of the pension cost are recorded depending on how the underlying asset or liability has changed, where the liability changes through financing decisions this amount is presented as part of financing - that is separate presentation is preferred.

3.10 The view taken in this paper is that changes in assets and liabilities relating to the provision of pension benefits arise from different drivers in the underlying assets and liabilities and hence have different predictive value. For this reason, they should be presented separately in reporting financial performance.

4 Presentation of service and interest cost

4.1 Having decided that different components of the income and expenses arising from the provision of pension benefits should be presented separately in the statement of comprehensive income, the next step is to consider how to present the individual changes arising from the movement in assets and liabilities. We might start by considering how to present the movement in liabilities.

Service cost

4.2 The presentation of service cost was discussed to some extent above, paragraphs 3.6-3.8. The fundamental point is that service cost is that part of the change in the liabilities for pension between one accounting period and the next that arises because pension benefits have been granted to employees in the period, generally in respect of their services during the period. It seems clear that this amount should be presented as an operating item.

4.3 It was concluded in Chapter 2 (at paragraph 4.24) that a liability to pay benefits includes only amounts that the entity is presently committed to pay by a legal or constructive obligation. It also concluded that modifications to benefits are taken into account when they occur, and not whilst they are merely possible (paragraph 4.69). Thus when the entity becomes committed to an increase in benefits, its recorded liability will increase. This will include situations giving rise to 'past service cost'.

4.4 This view implies that the change in benefits is a new transaction, and not merely the fulfilment of a pre-existing arrangement. The change in benefits has presumably been granted in exchange for services, and as such it should be recognised as part of the service cost.

4.5 It was also noted in Chapter 2 that, where benefits are related to salaries, some consider that a liability to pay benefits should be based on current rather than future salaries. On this view, it follows that the liability will increase when salaries are increased, as the value of the benefits (including those calculated by reference to prior years' service) is greater. That increase can be seen as an immediate cost of awarding an increase in salary and so it should also be reported as part of the service cost.

4.7 Management may wish to discuss the service cost for a period. Such a discussion may refer to the extent to which the total service cost for a period includes amounts such as those relating to changes in benefits and salary increases that may not be expected to recur.

4.8 **This paper adopts the view that the service cost should be reported within operating activities.**

Interest cost

4.9 The interest cost represents the 'unwinding' of the present value of the liability to pay future pensions. It thereby reflects the time value of money which many consider a financing item and hence should be presented within financing costs in the statement of comprehensive income. There are however others that consider financing should be representative only of the cost of liabilities that originate from an entity's capital-raising activities – this view would suggest that the interest cost would be reported in operating income together with the service cost for pensions. However, it would appear preferable for the interest on pension liabilities to be reported within financing as it represents the cost of deferring settlement of a liability: if separate information on interest on capital instruments is required, this could be provided by analysis of the amounts within financing.

4.10 In July 2006 the IASB, as part of Phase B of its Presentation of Financial Statements project, considered the distinction between amounts that form part of the return on business assets (operating) and amounts that form part of the return to providers of finance (financing). As part of this discussion the IASB considered the practical difficulties of deciding which amounts should form part of financing.

4.11 The IASB and FASB have developed a working format for presenting information within the basic financial statements. The format divides the statement of comprehensive income into business, discontinued operations and financing. The business category is then sub-divided into operating category and investing category. The investing category would include assets and liabilities that are not related to financing the entity's business activities that management views as not integral to its business activities.

4.12 In phase B of the project it would seem the interest arising on the unwinding of pension liabilities might be classified as part of business but included in the investing category. This would arise where management do not consider pensions to be part of the financing for the entity's business activities.

4.13 However, at present IAS1 does not provide the category discussed above and therefore the question which arises is whether the 'unwinding' of the pension liability should be part of financing costs. It would seem, given separate presentation is preferred, that although the cost does not arise from an entity's capital raising activities it should be included in financing costs.

4.14 **It is concluded that the unwinding of the liability for pensions should be presented within financing costs as it represents the interest cost (time value of money) arising on the liability to pay pension benefits at a future date.**

5 Presentation of the movement in assets (expected and actual return)

5.1 Presently, International, US and UK standards all require the "expected" return on plan assets to be recognised and reported within profit or loss.

5.2 Those who consider the expected return on assets should be reported as part of profit or loss do so because it provides an insight into how the assets of the plan are predicted to contribute towards funding the liabilities of the plan. The expected return on assets may therefore assist in predicting an entity's contributions to the plan.

5.3 Those that hold this view also consider that reporting the expected return on assets allows users to assess "underlying sustainable earnings". They are concerned that reporting the actual return on assets would introduce significant volatility into reported income and earnings per share. In their view, this does not reflect the fact that the assets of a pension plan are held with a view to producing a relatively secure long-term return that will assist in funding pension liabilities and so the fluctuations in market values do not affect the relatively stable cash flows between the employer and its pension plan. They

would suggest that this long-term perspective is appropriate, and makes short-term volatility irrelevant.

5.4 In contrast, those that reject the use of the expected return suggest that the expected return on assets is, at best, an amount estimated for budgetary purposes rather than the outcome from an economic event. They therefore believe there is no conceptual reason for including the expected return on assets in the statement of comprehensive income.

5.5 They consider that the use of the expected return is a way of “smoothing” and can lead to entities reporting income which is not representative of the actual return on assets held to fund pension liabilities. This is exacerbated as the difference between the expected and actual return on assets is treated as part of actuarial gains and losses and presented either outside profit or loss as part of other comprehensive income or spread over future accounting periods

5.6 Those that support this view also question the estimation of the expected return on assets. They note that expected return is often not management’s assessment of the return but that recommended by professional advisors. They also considered that estimates of returns are based on market expectations rather than a unique assessment of the individual asset portfolio held by the pension plan - that is market trends are followed rather an individual assessment made.

5.7 Finally those that do not support the use of the expected return also reject the argument that assets of a pension plan are held with a long-term view and that changes in market values are therefore irrelevant. They consider that it is not self evident that gains and losses will reverse—this may be the objective of investment policies but that objective may not be realised. It may also be noted that there is no non-arbitrary means of distinguishing irrelevant short-term changes from relevant long-term changes.

5.8 The purpose of financial statements clearly includes providing a report on the transactions and events that have taken place in an accounting period. The expected return on assets does not represent a transaction or event of the period, and therefore should not be reported in the financial statements. As noted above, users of financial statements find the expected return on assets significant, but it would be possible to meet this need by supplementary disclosure rather than by including the expected return in the primary financial statements.

5.9 **For the above reasons, it is concluded that financial statements should report the actual, rather than the expected return on assets, and that disclosure of the expected return should be required.**

5.10 This conclusion, however, leaves open the question of what the actual return on assets is. In part, the debate questions whether financial returns can be analysed between income (dividends) and capital growth (gains or losses that arise on holding investments).

5.11 Financial statements have in the past sometimes made a distinction between dividend income and capital growth. The ‘dividend irrelevancy theory’ argues, however, that the pattern of dividends is irrelevant. That is, the value of a holding of a portfolio of equities should not be affected by the receipt of

a dividend, because the value of equities will be reduced by the amount of the dividend received. This suggests that income and capital can be allocated only, if at all, arbitrarily.

5.12 Opponents of the 'dividend irrelevancy theory' argue the 'traditional view'; which is that at any particular point in time £1 of dividends is somehow more valuable than £1 of retained cash. Proponents of this view use the dividend growth model to support their argument. They argue that an entity by retaining part of its cash flow for reinvestment is replacing a certain cash flow (dividend now) with an uncertain future cash flow (future capital growth). These proponents draw a distinction between income (dividends) and capital growth.

5.13 The arguments of traditionalists are weak when analysed from a theoretical point of view. One counter argument is, assuming a perfect capital market, if two companies are identical in every respect except that their dividend retention ratios differ, and if the market values retained earnings differently from dividends, the market prices of the companies will be in disequilibrium. This will allow investors to undertake profitable arbitrage transactions, replacing dividends by selling part of shareholdings.

5.14 This analysis suggests that it is inherently difficult to separate income (dividends) from capital growth and therefore splitting the actual (total) return on assets between realised and unrealised transactions does not provide useful information to users of financial statements.

5.15 **For this reason it is concluded that the total actual return on assets held to fund pension liabilities should be reported in financial statements.**

5.16 Having determined that the actual return should be reported, the next question to consider is where it should be presented. There is an economic relationship between the actual return on assets and the financing costs (interest on unwinding the pension liability). That is, investment strategies are designed to match the cash flows required to settle pension liabilities and therefore the return on investments and the unwinding of the pension liability should be presented together in the same section, that is, within financing.

5.17 Separate presentation of the return on assets within the financing section also appears to be consistent with the direction that Phase B of the IASB/FASB project on financial statements presentation is taking.

5.18 One further issue that needs to be considered is that of negative returns on assets held to fund pension liabilities. Where the fair value of the assets fall from one accounting period to the next then it would seem sensible to include the negative returns either as part of financing costs or part of financing income as a negative amount.

5.19 **It is concluded that the actual return on assets held to fund pension liabilities should be presented separately as financing income in the statement of comprehensive income.**

6 Change in the rate of discount

6.1 It has now been argued that both the interest cost on liabilities and the total return on assets should be reported as financing items. A further question is how changes arising from the movement in interest rates should be presented (at present changes in the interest rate are part of actuarial gains and losses). It may be noted that Asset Liability Management (ALM) is a widely used technique designed to reduce risk in investment portfolios for pension plans. ALM aims to build a portfolio of assets (using financial instruments of varying degrees of sophistication) – that more closely replicate the characteristics of the pension plan payment profile. The aim is to immunise liabilities against changes in the interest rate.

6.2 Where possible, using ALM techniques, price changes in the assets would have an equivalent change in the valuation of liabilities. The total financing effect should then be zero. This would suggest that valuation changes due to interest rates should be shown in the same category as interest expense arising on unwinding of the pension liability and the actual return on assets and not part of actuarial gains and losses.

6.3 It is noted above that the interest expense represents the time value of money, arising from the liabilities being one year closer to payment. A change in the discount rate also represent a change in the time value for money and hence should be included as part of the financing costs.

6.4 **In the light of the above, it is concluded that changes in the interest rate should be presented as part of financing costs.**

7 Actuarial gains and losses

7.1 Current accounting standards use the term ‘actuarial gains and losses’ to refer to changes arising from the the remeasurement of the pension deficit or surplus at the end of one accounting date in comparison to a previous accounting date, other than those that are separately identified. They include:

- changes in the assumptions from one period to the next, for example staff turnover rates, early retirement rates or mortality rates;
- differences between the assumptions used in measuring the scheme liabilities and actual experience during the period (‘experience differences’);
- the difference between the expected and the actual return on investments; and
- the effect of changes in the discount rate.

7.2 It has been concluded above that the actual return on investments should be reported in financial statements and that the change in the discount rate used for liabilities should be reported as financing.

Under that view, these items would no longer fall within 'actuarial gains and losses' and only changes in assumptions and experience differences would remain.

7.3 It will be recalled that it was concluded in Chapter 4 that the balance sheet position should reflect the actual surplus or deficit in the pension plan, and that there is no place for deferred recognition. Therefore the remaining task is to consider where actuarial gains and losses should be presented in the statement of comprehensive income.

7.4 A view that has been considered is whether actuarial gains and losses should be classified into two categories; actuarial gains and losses management may be considered to control (for example staff turnover rates, wage rates) in contrast to actuarial gains and losses that were considered to arise from external events (for example, changes in the rate of inflation). Those that support dividing actuarial gains and losses in this way consider that such a distinction could reduce reported volatility in profit or loss if items that were deemed to be outside managements' control were presented within other comprehensive income. This would, they believe, provide a better insight into management's control of resources.

7.5 Those that do not support this view consider management have to manage resources taking into consideration external factors. As a consequence any "splitting" is arbitrary and does not represent a realistic portrayal of the management of economic resources whether relating to internal or external factors.

7.6 It is concluded that actuarial gains and losses should not be split between those relating to internal and external factors as any such splitting is arbitrary.

7.7 Current accounting standards currently permit or require actuarial gains or losses to be recognised outside of profit or loss. IAS 19 permits an approach under which they are reported in the statement of other comprehensive income; SFAS 158 requires them to be reported as 'other comprehensive income' and similarly the UK standard, FRS 17, requires actuarial gains and losses to be reported in the statement of total recognised gains and losses.

7.8 The rationale for items to be reported either as part of profit or loss or excluded from profit or loss is not clearly defined in accounting literature. The IASB notes in the basis for conclusions for IAS 1 (paragraph BC 51) that:

The Framework does not define profit or loss, nor does it provide criteria for distinguishing the characteristics of items that should be included in profit or loss from those items that should be excluded from profit or loss.

7.9 Some would favour an approach under which actuarial gains and losses were initially reported in other comprehensive income, and then 'recycled' into profit or loss in a later accounting period. This seems to be based on the view that actuarial gains and losses are part of the costs of employing staff and therefore need to be recognised as part of profit or loss at some point.

7.10 The recycling of gains and losses would also require a methodology for recycling to be specified. Under the deferral mechanisms discussed in Chapter 4 for recognition of the net asset or liability relating to the pension liabilities the asset or liability is generally recognised over the remaining service life of employees. Whilst it would be possible to prescribe such a rule for recycling, it is difficult to identify a conceptual justification for it.

7.11 It is beyond the scope of this paper to consider whether there could be a rationale for distinguishing items that are included in profit and loss from those that are reported in other comprehensive income. However, it may be noted that the IASB and FASB have expressed a tentative view that all current period changes in assets and liabilities should be presented in one of the functional categories in the statement of comprehensive income, thereby rendering 'other comprehensive income' and the mechanism of recycling unnecessary. The IASB and FASB recognise this is a long-term goal.

7.12 As noted above, under the proposals in this paper, actuarial gains and losses would represent only changes in assumptions and experience differences—and it is difficult, if not impossible, to distinguish between these two classes, both of which may fairly be described as changes in estimates. It is difficult to justify reporting such changes in estimates other than as part of profit or loss, immediately they arise. This has the following advantages:

- (i) the financial statements are easy to understand; and
- (ii) the treatment is consistent with the treatment of changes in the estimates of other provisions.

7.13 Although this would introduce a significant degree of volatility into the profit and loss account this is not necessarily a fatal objection, provided the reported volatility is representative of economic events of the period and their impact on the entity.

7.14 It is concluded that, as actuarial gains and losses are essentially changes in the estimate of the liability for pensions from one accounting period to the next, there is no justification to present them other than as part of profit or loss.

7.15 Having formed the view that actuarial gains and losses should be recognised immediately they are incurred as part of profit or loss, the next issue is how they should be presented. IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors' addresses changes in estimates, and notes that as a result of uncertainty inherent in business activities, many items in financial statements cannot be measured with precision but can only be estimated (paragraph 32). A revision in an accounting estimate does not relate to a prior period (paragraph 34).

7.16 A revision to an estimate is often recognised in the same position in the statement of comprehensive income as the original estimate is recognised, although this is not a specific requirement of IFRS. Reporting actuarial gains and losses in the same line items as previous estimates would therefore be consistent with practice for other changes in estimates.

7.17 However, it might often be difficult to assess how much of an actuarial gain or loss relates, for example, to service cost and how much to interest. Given this difficulty, and the inherent uncertainty in measuring pension liabilities, separate presentation seems warranted. Another advantage of separate presentation is that it permits a clear distinction to be made between this year's performance and changes arising from re-measurement of prior year items. This should be of assistance to those who wish to assess "sustainable earnings", or otherwise form a view on the prospects for future income.

7.18 It is also necessary to consider whether the changes should be presented within or outside operating income. Actuarial gains and losses are simply revisions to estimates. They differ from other items that might be regarded as operating items in that they do not represent transactions of the period. Nor does the amount of actuarial gains and losses in one period have any clear relationship to the amount in future periods, so the predictive value of actuarial gains and losses is different from many other items that might be regarded as operating.

7.19 It therefore seems likely that including actuarial gains and losses with operating income would create confusion in and therefore it seems better to exclude them from operating income.

7.20 **It is concluded that actuarial gains and losses should be presented as a separate line item as part of profit or loss outside of operating activities.**

8 Summary

8.1 This Chapter considers how changes in the pension liabilities and in the assets held to fund those liabilities should be reported in the financial performance statement. It does not seek to address all the questions that are currently being debated in the context of financial statement presentation (such as whether measures of earnings should be presented), but builds on the requirements of IAS 1 (revised September 2007) 'Presentation of Financial Statements', and notes that current work by the IASB and FASB is considering a distinction between business and financing activities. It assumes that in the future statements of financial performance will provide separate disclosure of the following:

Operating activities;

Financing; and

Other financial performance

(Section 2)

8.2 The paper considers the view that changes in liabilities and/or assets for a period should not be disaggregated, but favours an approach under which different components of the expense are presented separately (even where a 'net' asset or liability is reported in the balance sheet), as different components seem to have different drivers and predictive value. (Section 3)

The financial reporting of pensions

8.3 The paper proposes that the changes in assets and liabilities should be presented as follows:

Service cost—within operating activities (Paragraphs 4.2-4.8)

Finance cost of pensions—within financing (Paragraphs 4.9-4.14)

Effect of change in the discount rate—within financing (Section 6)

Actual return on assets—within financing (Section 5)

Actuarial gains and losses—in the profit and loss account, within other financial performance. (Section 7)

8.4 A notable difference from the requirements of current accounting standards is the proposal that the financial statements should report the actual return on assets, rather than the expected return. However, as users find the expected return on assets useful, it is proposed that it should be disclosed in a note to the financial statements. (Section 5)

8.5 'Actuarial gains and losses' would differ from that arising under present accounting standards because they would not include the effect of changes in the discount rate, nor the difference between the expected and actual return on assets. (Paragraphs 7.1-7.2)

An alternative presentation model for interest expense and expected return on assets

A1 This Chapter has expressed the view that the following items should be reported within the financing section of the income statement:

- The actual return on assets
- Interest cost
- The effect of changes in the discount rate.

In part, this conclusion was justified by the close economic relationship between these items.

A2 Some do not support this conclusion because, although they agree that there is an important economic relationship between the interest cost and the income on plan assets, they consider the effect would be to introduce undue volatility into the reported profit or loss.

A3 They would favour an alternative presentation model under which all of these items would be presented outside of the profit and loss account. They would agree that this presentation would be inconsistent with IAS 1 and the general framework for other IFRSs. However, supporters of this approach give more weight to the usefulness of information presented in the financial statements than to a conceptually pure approach.

A4 As this Chapter of the discussion paper has been based on IAS 1 as a framework for its proposals on presentation, this approach has not been considered further.

Chapter 9: Disclosures in the employer's financial statements

1 Introduction

1.1 Earlier Chapters of this discussion paper have noted that some of the concerns (and alternative views) highlighted could be addressed through improved disclosures. In this Chapter we will review these areas and outline disclosures that provide an insight into the amounts reported in the financial statements and the risks and rewards that arise from the provision of pension benefits.

1.2 In developing disclosure proposals in this Chapter for financial statements only a limited distinction has been made between disclosures to be provided in the financial statements themselves and disclosures that might be provided outside the financial statements as part of a management commentary. The reason for this is because at the time of writing no international guidance exists regarding information to be presented as part of a management commentary. Although in October 2005 the IASB issued a discussion paper titled 'Management Commentary' the IASB's active agenda does not specify when the proposals in the discussion paper might be developed.

1.3 As this Chapter does not distinguish in detail between disclosures provided in the financial statements themselves and those provided in a management commentary the term 'financial statements' should be taken as including the management commentary, unless the context requires otherwise.

1.4 It is, however, recognised that some of the disclosures proposed might usefully be provided as part of the management commentary, including alternative measures of the liability to pay benefits and some disclosures regarding risks and rewards that management believes may affect the entity's long-term value.

1.5 In developing disclosures for pensions it was initially decided to identify what the objectives for disclosures should be and then from this, identify the disclosures that support these objectives.

2 Objectives for disclosure

2.1 To identify the objectives that arise from the provision of pension benefits it would seem the first step is to identify who the users of financial statements are then to try and assess their needs. By considering users' needs it should be possible to develop clear disclosure objectives.

2.2 A user of the financial statements may review the disclosures relating to pensions for different reasons, for example a beneficiary of a pension plan (who may also be an existing employee) may read financial statements in an attempt to understand the strength of the employer's covenant towards the plan; whereas an investor or potential investor may read the disclosures relating to pensions to gain an understanding of how an entity's obligations towards the plan affect the resources available to the entity (i.e. future cash flow requirements of the plan).

2.3 The IASB Framework¹ states that:

The users of financial statements include present and potential investors, employees, suppliers and other trade creditors, customers, governments and their agencies and the public. They use financial statements in order to satisfy some of their different needs for information.

...

While all of the information needs of these users cannot be met by financial statements, there are needs which are common to all users. As investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

2.4 The IASB's framework applies to general purpose financial statements and notes that by focusing on the needs of investors the needs of other users can be satisfied. In attempting to identify the objectives for disclosures for pensions it is clear that the needs of users of financial statements are wide and varied. It is therefore necessary to focus disclosures on the needs of investors and potential investors, as noted in the IASB framework. Without this focus there is the potential to identify disclosure requirements that are unfocused and cumbersome and which simultaneously fail to provide an understanding of the risks and rewards arising from the provision of pension benefits.

2.5 Further, in identifying objectives for disclosures, the assumed level of knowledge a user of the financial statements is considered to hold, must also be taken into consideration. The IASB Framework notes:

An essential quality of the information provided in financial statements is that it is readily understandable by users. For this purpose, users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.(paragraph 25)

2.6 Having determined that disclosures should focus on the needs of investors and that users (investors) are assumed to have a reasonable knowledge of business the next step is to determine objectives that support investors needs. One theme that was repeated by the project's advisory groups was a concern regarding the volume of disclosures provided in existing financial statements

¹ Paragraphs 9 and 10.

regarding the provision of pension benefits. Some noted that the volume of disclosures provided in relation to pension obligations was disproportionate compared to other areas in the financial statements. Others considered that often the volume of disclosures was not proportionate to the information content provided by the disclosures.

2.7 Taking these views into consideration it was decided that the principal objective for disclosures should be to explain the risks and rewards arising from the provision of pension benefits, having regard to the materiality of the amounts involved. In this way an entity would only be required to provide disclosures that were material to its position, rather than provide an exhaustive list of disclosures and hence disclosures that did not provide relevant information to a user.

2.8 Having determined the principal objective, consideration was given to more detailed objectives that would assist in identifying disclosure requirements. In 2006 the ASB undertook a review of the disclosure requirements required for defined benefit pension schemes. The review was instigated following feedback from users of financial statements highlighting a concern that financial statements did not include sufficient information to allow users of the financial statements to obtain a clear view of the risks and rewards arising from liabilities to pay pension benefits and the assets held to fund those liabilities.

2.9 The work undertaken by the ASB in 2006 ran simultaneously with the research work being undertaken in developing this discussion paper. The ASB therefore requested the assistance of the project advisory panel and working group to support its work in reviewing the disclosure requirements for defined benefit schemes. In view of this review it was considered that the objectives determined here should assist in developing disclosure objectives for this discussion paper.

2.10 In January 2007 the ASB issued a non-mandatory reporting statement which took into consideration comments received on a draft reporting statement following a period of consultation. The reporting statement set out the following objectives for disclosure:

- (a) *the financial statements contain adequate disclosure of the cost of providing retirement benefits and the related gains, losses, assets and liabilities;*
- (b) *that the users of financial statements can obtain a clear view of the risks and rewards arising; and*
- (c) *the funding obligations the entity has in relation to liabilities of defined benefit schemes are clearly identified.*

2.11 It might be noted that objectives (b) and (c) above were developed to respond to the users of financial statements, who in January 2006 wrote to the Financial Times (FT) noting:

... all too often the disclosures in relation to pension liabilities are not sufficient to allow investors to assess the impact of changes ...

The letter highlighted the concerns of analysts regarding mortality assumptions and the sensitivity of assumptions (particularly the discount rate).

2.12 Having reviewed the reporting statement it was considered that the objectives set out in the statement did provide a basis for developing disclosures in this discussion paper. The objectives need, however, to be amended to take into consideration the focus of this discussion paper, which is to consider the assets and liabilities that arise from the employer's promise to provide pension benefits. This is in contrast to previous accounting standards that categorised pensions by types of arrangements.

2.13 In developing this discussion paper the objectives for disclosure are considered to be:

Disclosures should provide information that explains the risks and rewards arising from the provision of pension benefits, having regard to the materiality of the amounts involved, such that:

- (a) **financial statements contain adequate disclosure of the cost of providing pension benefits and any related gains, losses, assets and liabilities;**
- (b) **users of financial statements are able to obtain a clear view of the risks and rewards arising from liabilities to pay pension benefits and the assets held to fund those benefits; and**
- (c) **the funding obligations of the entity, in relation to liabilities to pay pension benefits, are clearly identified.**

2.14 The objectives set out below have been amended to reflect the focus of this discussion paper, which does not draw a distinction between defined benefit and defined contribution arrangements. Where an entity operates a pension arrangement similar to a defined contribution arrangement, a number of the disclosures proposed in this Chapter would not be applicable. In this instance, disclosure would not be made.

3 The financial statements contain adequate disclosure of the cost of providing pension benefits and any related gains, losses, assets and liabilities

3.1 The aim of this objective is to provide a user of financial statements with information about the amounts presented in the financial statements and how these amounts relate to each other. It might be useful to consider the amounts presented in the financial statements in the following categories:

- the cost of providing pension benefits;
- assets and liabilities relating to pension benefits; and
- disclosures regarding the measurement of liabilities to pay pension benefits.

Cost of providing pension benefits

3.2 The preliminary view formed in Chapter 8 'Presentation in financial statements' is that changes in assets and liabilities for pensions should be presented in the line item to which they relate in the statement of comprehensive income (separate presentation). In forming this preliminary view two views were explored; the first view was that pension cost should be a single item in the statement of comprehensive income with footnote disclosure. The second view was that the pension cost arises from the changes in the underlying assets and liabilities for pensions which are themselves affected by different drivers. Those that support separate presentation consider that the drivers of the pension cost can be separated and managed independently from each other and hence should be presented as part of the line item in the statement of comprehensive income to which the variable relates.

3.3 It would seem, regardless of the view adopted, there is a need to reconcile the cost in the statement of comprehensive income to the movement in the assets and liabilities; analysing separately the components of pension costs and thereby providing greater information about the "drivers" which affect the cost of providing pensions.

Assets and liabilities relating to pension benefits

3.4 Chapter 3 of this discussion paper discusses the identification of assets and liabilities including gross or net presentation of pension assets and liabilities. The different scenarios considered highlight that a user of financial statements needs to understand the amounts presented in the financial statements (i.e. the assets and liabilities) and how the movement in related assets and liabilities over the reporting period has affected the reporting entity.

3.5 IAS 19 requires a reconciliation of the opening and closing balances of the defined benefit obligation showing separately, if applicable, the effects during the period attributable to each of the

elements² that give rise to the movement in the assets or liabilities. There seems little debate that reconciliation is required of the opening and closing position for liabilities to pay pension benefits and (if applicable) the assets held to fund these benefits showing separately changes in the drivers that affect the assets and liabilities.

Disclosures regarding the measurement of liabilities to pay pension benefits

3.6 As noted earlier analysts have previously highlighted a concern regarding the disclosures in relation to pension liabilities. Analysts raised a concern that disclosures were not sufficient to allow investors to assess the affect of changes in the assumptions that underlie the measurement of pension liabilities. We might explore this concern by reviewing three areas regarding pension liabilities:

- assumptions used to measure liabilities (paras 3.7 to 3.11 below);
- sensitivity of the principal assumptions used to measure liabilities (paras 3.12 to 3.17 below); and
- alternative methods of measuring pension liabilities (paras 3.18 to 3.31 below).

Assumptions used to measure liabilities

3.7 There seems little question that a user of the financial statements needs to understand the principal assumptions used to measure liabilities, but perhaps the more important question is whether any future financial reporting standard should specify the format for presentation of those assumptions and, specifically, how to disclose mortality assumptions.

3.8 Mortality rates have become an area on increasing interest, this was an area of particular concern noted by UK analysts. These users considered that greater information should be provided about increases in life expectancy and how this affected pension liabilities.

3.9 The increased focus on mortality rates arises from a number of factors, including:

- (i) although many plans are closed to new entrants, plans remain exposed to reducing mortality rates;

² Chapter 8 discusses the elements that give rise to the movement in pension assets and liabilities.

- (ii) recent experience confirms that mortality rates for the retired population in the UK have continued to fall rapidly, with no real signs of slowing³; and
- (iii) studies have suggested that mortality assumptions in the EU vary considerably⁴.

3.10 The format for disclosure of the mortality assumptions is particularly important. Many entities use standard mortality tables; however disclosure of these tables provides only the source for the assumption, not the assumption itself. A more informative disclosure is the average number of years post retirement pensions are expected to be paid to individuals.

3.11 In addition to the disclosure of the assumptions, some consider that it is important that the disclosures set out in the financial statements provide not only details of the assumptions but an explanation of why assumptions have changed from previous periods.

Sensitivity of the principal assumptions used to measure liabilities

3.12 As noted previously, concern has been expressed by analysts regarding the sensitivity of liabilities to movements in the underlying assumptions. In developing its non-mandatory reporting statement the ASB considered whether to recommend the disclosure of a sensitivity analysis. Although the ASB considered the views of some commentators, that additional cost may outweigh the benefits of the disclosure, they also took into consideration the inherent uncertainties that underlie the assumptions and considered that such information would provide a useful assessment of the uncertainties that underlie the assumptions. The reporting statement therefore recommends:

The financial statements should disclose a sensitivity analysis for the principal assumptions used to measure the scheme liabilities, showing how the measurement of scheme liabilities would have been affected by changes in the relevant assumptions that were reasonably possible at the balance sheet date.

3.13 In contrast IAS 19 paragraph 120A(p) requires:

... the amounts for the current annual period and previous four annual periods of:

- (i) *the present value of the defined benefit obligation, the fair value of the plan assets and the surplus or deficit in the plan; and*
- (ii) *the experience adjustment arising on:*
 - (A) *the plans liabilities expressed either as (1) an amount or (2) a percentage of the plan liabilities at the balance sheet date and*

³ The Actuarial Profession letter to actuaries holding Life Actuary certificates and Scheme Actuary certificates - 10 July 2007.

⁴ Cass Business School - Mortality Assumptions used in the calculation of Company Pension Liabilities in the EU

(B) *the plan assets expressed either as (1) an amount or (2) a percentage of the plan assets as the balance sheet date.*

3.14 It is noted in the Basis for Conclusion to IAS 19 that the IASB believes that information about the trends of a plan is important so that users have a view of the plan over time not just at the balance sheet date. Information about trends does not, however, provide information about how liabilities to pay pension benefits are affected by changes in the assumptions used to measure the liability – rather it provides information about the accuracy of the assumptions used.

3.15 In relation to providing sensitivity information when the FASB issued SFAS 132 ‘Employers Disclosures about Pensions and other Post retirement Benefits’ it noted in the Basis of Conclusions⁵ that it was concerned that providing sensitivity information for individual assumptions, while holding all other assumptions constant, may be misunderstood and may not adequately take into account the interdependency of certain assumptions.

3.16 In March 2007 the Association of British Insurers (ABI) published a research paper ‘Understanding Company Deficits’. In this paper the ABI noted that the FRS 17 deficit is essentially a static measure of a scheme’s position. The arguments set out in the paper suggested that analysts and shareholders want improvements in the degree of FRS 17 disclosure particularly on pension solvency positions. In its paper the ABI noted that publishing the assumptions used to calculate the FRS 17 deficits and explaining how sensitive these deficits are to changes in them is a step in the right direction, but not a complete solution to the problem.

3.17 Although previous accounting standards had rejected providing sensitivity information regarding the measurement of liabilities to changes in assumptions, it seems that more recent thinking would support the disclosure of such information. It might be noted that IFRS 7 ‘Financial Instruments Disclosures’ requires disclosures that enable users to evaluate the significance of financial instruments for the entity’s financial position and performance and the nature and extent of risks arising from financial instruments. As such, it requires a sensitivity analysis for the market risks an entity is exposed to. This might suggest users of financial statements have developed their understanding of the information provided by sensitivity analysis.

Alternative methods of measuring pension liabilities.

3.18 In Chapter 5 of this discussion paper ‘Measurement of liabilities to pay benefits’ the candidate bases for measuring liabilities are discussed. After consideration of the alternative bases for measuring liabilities, a current settlement amount is preferred. Regulatory measures are considered as an alternative to ‘running off’ the liability or ‘buying out’ the benefits with a suitable insurance entity but rejected as it is considered that regulatory measures should not replace measures derived from general accounting principles.

⁵ Paragraph A42 of SFAS 132 (revised 2003).

3.19 In addition to the discussion in Chapter 5 it is also noted in Chapter 2 that, whether or not the effect of future salary increases is included as part of the liability to pay pension benefits, it is necessary to disclose the amount of the liability with and without salary increases as both measures provide relevant information about present and expected future obligations.

3.20 There are clearly alternative measures for the liability to pay pension benefits, the question that arises is whether alternative measures, in addition to the measurement required by the financial reporting standard itself, should be disclosed.

3.21 Some are of the view that disclosing alternative estimates of the liability to pay pension benefits allows users of financial statements to gain a better understanding of the "variability" of the liability to pay pension benefits and hence such disclosure responds to the ABI comment that FRS 17 (or its equivalent) is a static measure.

3.22 Those that are of this view consider the disclosure provides useful information. They consider, for example, a regulatory measure of pension liabilities, although rejected for use in the financial statements themselves, provides a user of the financial statements with an understanding of the regulatory funding requirements an entity has. Additionally disclosure of a regulatory amount might provide a member of a pension plan with information relevant to an assessment of the security of their pension arrangement.

3.23 Similarly others support the disclosure of measurement of the liability with and without the effect of future salary increases. Disclosure of the accrued benefit obligation (ABO) is required by SFAS 132⁶. Those that support disclosure of the ABO consider it provides a solvency estimate of the pension liability at the balance sheet date where the measure in the financial statements themselves is on a projected benefits basis.

3.24 Another disclosure recommended by the ASB in its non-mandatory reporting statement is that of the buy-out amount. Some consider that the buy-out amount is a valuable disclosure as it provides a 'worst case' view of the accrued liability and is based on market conditions. In the UK this amount is made available to members of pension plans through annual funding statements. The ASB took into consideration the differing views regarding disclosure of this amount but decided, ultimately, that they could find no justification that information made available to members of defined benefit schemes and/ or trustees (manager of plans) should not be made available to investors.

3.25 Others do not support the disclosure of alternative measures for the liability to pay future pension benefits. They consider that alternative measures do not inform users but create confusion and give rise to incorrect decisions being made about pension liabilities. In particular many oppose disclosure of the liability based on the buy-out amount arguing it causes confusion about future funding requirements and is not consistent with the assumption regarding going concern.

⁶ SFAS 132 paragraph 5(e).

3.26 Those that do not support disclosure of alternative measures for the liability consider that the provision of sensitivity information provides useful information regarding alternative measures of the liability and agree that alternative measures may confuse rather than inform users.

3.27 Finally others that do not support disclosure of alternative measures of the liability to pay pensions argue that financial statements should contain disclosures about the amounts presented in the financial statements themselves rather than alternative measures which are not included in the financial statements. They consider that the appropriate place for such disclosures is in the management commentary.

3.28 A further problem with recommending that alternative measures of the pension liability are disclosed is that of costs and benefits. When the ASB recommended disclosure of the buy-out amount in its reporting statement, it took into consideration the fact that this information was already available to UK entities. Hence disclosure of this measure would not cause significant cost to be incurred.

3.29 Where alternative measures are required to be disclosed then the measure needs to be clearly defined either in the financial statements or prescribed by the financial reporting statement itself – otherwise information between entities may not be comparable and thereby create confusion.

3.30 There are clearly differing views regarding the disclosure of alternative measures for pension liabilities. As noted above one view is that the financial statements should only contain disclosures about the amounts contained in the financial statements themselves. A discussion about alternative measures (including regulatory or other amounts) and how management monitor and utilise the information provided from alternative measures should be provided in the management commentary. This approach would respond to the view that there is no justification for not disclosing amounts that are already made available to members of pension plans and/or trustees and management of the entity and hence equity holders are disadvantaged compared to others.

3.31 The above analysis suggests that;

- (i) alternative measures may provide useful information to the users of financial statements and where available, alternative measures should be disclosed (particular emphasis was placed on disclosure of the ABO as an alternative to the PBO where the PBO was used to measure pension liabilities);
- (ii) however the cost of providing these estimates must be balanced with benefit provided by the information; and
- (iii) where alternative estimates are available they could be discussed in the management commentary, rather than the financial statements themselves.

3.32 Set out in appendix to this Chapter is a list of proposed disclosures. This includes reconciliation of the amounts presented in the financial statements, details of the assumptions that underlie the measurement of liabilities to pay pension benefits, a sensitivity analysis showing the affect of changes in the assumptions and alternative measures (in the management commentary) where available.

4 Users of financial statements can obtain a clear view of the risks and rewards arising from liabilities to pay pension benefits and the assets held to fund those benefits

Understanding the relationship with the entity

4.1 In Chapters 2 and 3 of this discussion paper the nature of liabilities and types of pension arrangements are considered. These Chapters highlight the many different types of arrangements that arise from the provision of pensions benefits. To evaluate the effect these arrangements may have on the reporting entity, a user of the financial statements needs to understand the nature of an entity's arrangements. At present IAS 19 provides that:

An entity shall disclose information that enables users of financial statements to evaluate the nature of its defined benefit plans and the financial effects of changes in those plans during the period.

4.2 In addition to discussing the nature of arrangements, Chapter 3 also highlights the relationship and, particularly that the division of powers between the reporting entity and the pension plan are crucial in determining who has control of the pension plan. The nature of the relationship between the reporting entity and the trustees/ (managers) of a plan will be an indicator used to determine whether an entity controls the plan and therefore whether the plan is consolidated in the financial statements.

4.3 The analysis in Chapter 3 suggests, in addition to understanding the nature of defined benefit plans, a user also needs to understand the relationship between the entity and the plan. Providing greater information about the relationship between an entity and a pension plan would allow users to understand the extent to which an entity is able to influence arrangements between itself and the plan. It would also permit a user of the financial statements to evaluate the role of managers/trustees of pension plans. The role and level of independence attributed to managers/trustees of pension plans can vary between individual plans and between plans in different legal jurisdictions.

4.4 The ASB proposed in its draft reporting statement improved disclosures in this area – conscious of the importance of the independent role of trustees particularly in the UK. A number of respondents to the draft reporting statement were concerned that the proposals set out in the draft reporting statement would lead to cumbersome and/or boilerplate disclosures. However, some respondents agreed that there was a need to improve disclosures regarding the relationship between an entity and the plan but considered that the disclosures provided in financial

statements should focus on unusual or 'out-of-the ordinary' powers of, or constraints on, trustees/managers of plans.

4.5 The respondents to the draft reporting statement appeared to be focusing on the need for pension disclosures to provide information regarding risks and rewards that arise from arrangements to provide pension benefits. Many entities have risk management processes that aim to provide information to an entity's management about the most significant risks and how they are being managed. It was envisaged that enterprise risk management systems could provide the information required for the disclosures regarding the risk and rewards for pension liabilities.

4.6 It would therefore seem in understanding the risks and rewards that arise from the pension liabilities and the assets held to fund those liabilities, the first stage is to understand the nature of those assets and liabilities, which includes understanding the arrangements where the assets and liabilities are held in a separate plan. In addition it is also necessary to understand the relationship between the trustees/managers of the pension plan and that of the entity. In such circumstances entities that have risk management processes may already be monitoring these risk and rewards.

Nature of the liability

4.7 In section 3 above, proposed disclosure requirements have been set out regarding measurement of the pension liability. It might be argued that this information provides details of possible estimation errors in the measurement of the liability rather than an understanding of the pension liability itself. Providing a user of the financial statements with an understanding of the nature of the pension liability arguably includes providing information regarding, to whom pension benefits are or will be paid. The information that might be provided includes membership details of the plan, categorised between active employees; deferred members (that is former employees) and pensioners. In providing this information a user of financial statements is able to gain a better understanding of the nature of the pension liability and enhanced predictions about the future development of the pension liability.

4.8 In providing information about the nature of the liability one area that needs to be considered is future cash flows of the plan itself. The ABI, in its research paper, suggested financial statements should provide information about the projected cash flows relating to the pension liability. It noted:

While single point estimates of pension deficits provided by FRS 17 is useful, there is no question that looking at the underlying cash flow projections may also help understand the dynamic of DB plans.

4.9 The ABI noted that by looking at the stream of projected cash flows one had the potential to highlight shrinking or widening funding gaps. In this way the ABI were making reference to the solvency of the pension plan.

4.10 The ASB's reporting statement recommends the projected cash flows be disclosed. In making the recommendation to include the cash flows of the pension plan, the ASB took into consideration the view expressed by some respondents to the draft reporting statement that the cash flows were those of the pension plan and not those of the reporting entity and disclosures of another entity's cash flows was inappropriate. The ASB ultimately decided that understanding the cash flows of the plan was important as it permitted the user of the financial statements to understand the profile of cash flows including peak cash flows and hence the effect these would have on the resources available to the entity.

4.11 It should be noted that providing the information about how the liabilities of the pension plan are anticipated to be payable is quite separate from providing information about the entity's own funding obligations. These are both important areas to the users of financial statements – however the information about the liabilities is providing a user of the financial statements with information about risks arising from the nature of the liability whereas providing information about the entity's funding obligations is addressing the economic resources the entity has available. It is considered that both disclosures are important and provide relevant information to the user of financial statements.

Assets held to fund pension liabilities

4.12 Having considered disclosures regarding the liabilities to pay pension benefits the next area to consider is the risks and rewards arising from assets that are held to fund pension liabilities. At present IAS 19 requires the following disclosures:

for each major category of plan assets, which shall include, but is not limited to, equity instruments, debt instruments, property, and all other assets, the percentage or amount that each major category constitutes of the fair value of the total plan assets.

4.13 In addition IAS 19 requires the amounts included in the fair value of the plan assets for (i) each category of the entity's own financial instruments; and (ii) any property occupied by, or other assets used by, the entity.

4.14 The disclosure objective being considered in this section aims to provide information about the risks and rewards arising from the assets held to fund pension liabilities. The disclosure requirements of IAS 19 provides information only regarding the nature of assets held and does not extend to providing information regarding the risks and rewards of those assets. In recent times the investment strategies and assets held to facilitate these strategies have grown in complexity. There has, for example, been a growth in "Liability Driven Investment" approaches which seek to match liabilities to pay pension benefits with assets using more complex financial instruments. The nature of these investments require greater information than that provided by the existing requirements of IAS 19 (or FRS 17).

4.15 The disclosures that are proposed in this area have been adapted from IFRS 7 'Financial Instruments: Disclosures'. One of the objectives of IFRS 7 is to enable users to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed. As users of financial statements will be familiar with the disclosure requirements of IFRS 7 rather than develop new disclosures it is considered the requirements of IFRS 7 could be adapted. In addition it is considered that disclosures in this area should not be restricted to financial assets but include all financial instruments held in relation to pension liabilities. The recommended disclosures, adapted from IFRS 7, are:

For each type of risk arising from financial instruments held to fund pension liabilities, an entity should disclose:

- a. *the exposure to risk and how they arise;*
- b. *the objectives, policies and processes undertaken by the pension plan or the entity for managing the risk and the methods used to measure the risk; and*
- c. *any changes in (a) and (b) from the previous period.*

4.16 Finally in considering the risks and rewards arising from assets held to fund pension liabilities it is noted in Chapter 6 'Measurement of assets held to pay benefits' that:

The role of investment strategy in meeting obligations to pay benefits requires explanation (rather than recognition) in financial statements.

4.17 The investment strategy for assets held to fund pension liabilities will affect the future contributions required by the reporting entity. The reporting entity will need to fund future pension liabilities that cannot be met from the returns on assets themselves. It was noted in Chapter 8 that users of financial statements use the expected return on assets to predict future investment returns and thereby future funding requirements on entity has towards the plan.

4.18 It might also be noted that SFAS 132(R) 'Employers' Disclosures about Pensions and Other Post Retirement Benefits' requires a narrative description of investment policies and strategies including target allocation percentages or range of percentages for each major category of plan assets.

4.19 It would therefore seem that an entity needs to provide an explanation of the investment strategy (including the expected return on assets) in addition to information about the assets held and the risks arising from the assets held.

4.20 **As noted a list of suggested disclosures is provided in Appendix to this Chapter. The suggestions include information regarding the nature of the plan and its relationship with the entity; information about the plan's expected cash flows; greater information about the nature of assets held by the plan and a description of investment strategies.**

5 The funding obligations an entity has in relation to liabilities to pay pension benefits are clearly identified.

Inter-relationship between assets held of fund liabilities and funding obligations

5.1 It is noted in Chapter 6 (paragraph 2.4) that:

Some commentators have been concerned that the present accounting model fails to reflect how liabilities to pay benefits are expected to be met out of future cash flows from assets and contributions from employers and employees.

5.2 What appears to be being addressed here is the solvency of the scheme. The mere existence of a deficit in the scheme does not necessarily imply that a scheme is insolvent and will not be able to pay pension obligations as they fall due. It would therefore seem that disclosure is required to link the investment strategy and the liabilities to pay pensions. It is this "gap" (the gap between liabilities and investment returns) that an entity will need to fund via contributions.

5.3 It would therefore seem that disclosure is required in the financial statements that links together information about the liabilities of the scheme with the assets held to fund those liabilities. This information is likely to be presented in a narrative format that explains how the entity plans to fund its obligations in contrast to information disclosed regarding the pension liabilities.

Funding obligations

5.4 In relation to the entity's funding obligations IAS 19 requires an entity to disclose the employer's best estimate, as soon as it can reasonably be determined, of contributions expected to be paid to the plan during the annual period beginning after the balance sheet date. In view of the long term nature of pension liabilities this would appear to provide limited information to a user of financial statements.

5.5 When the ASB considered the disclosure requirements for funding obligations they took into consideration the funding regime brought about by the Pension Act 2004. The 2004 Act was the UK response to the EU regulation on pensions and thereby similar provisions can be found across Europe. In its reporting statement the ASB recommended that the following information with regard to funding obligations, should be disclosed in financial statements:

- (i) agreements reached between trustees (managers) of defined benefit schemes and the reporting entity regarding not only agreed contributions but also regarding funding principles; and
- (ii) details of 'regular' and 'special' contributions.

5.6 There were a number of concerns raised by respondents regarding these recommendations. Most notably respondents were concerned that funding obligations are very often subject to renegotiation and that the amounts were, at best, estimates. The ASB were not convinced by this argument and considered that the nature of the agreement could be disclosed.

5.7 **The suggested disclosures in Appendix to this Chapter propose disclosures are made regarding how the liabilities for pensions will be met through investment policies and greater information about funding agreements reached between the entity and the plan.**

6 Special cases for disclosure

Multi-employer schemes

6.1 One area that has not yet been addressed is that of multi-employer plans and whether separate disclosure requirements should be specified. IAS 19 requires an entity to make the same disclosures for multi-employer plans as that for its own plans.

6.2 Chapter 10 of this discussion paper addresses the financial reporting of multi-employer plans and concludes that the recognition and measurement principles proposed in this discussion paper are equally applicable to multi-employer plans. The question that needs then to be considered is whether the disclosures proposed in this Chapter are also applicable. We can consider their applicability by reviewing each of the disclosure objectives in relation to multi-employer plans.

6.3 The first objective addresses the cost of providing benefits and the assets and liabilities arising from the provision of benefits. In essence this disclosure objective seeks to provide an understanding of the amounts presented in the financial statements. There seems no reason why the amounts that are presented for multi-employer schemes should not be explained in the same manner.

6.4 The second objective addresses the risks and rewards that arise from the provision of pension benefits and the related assets and liabilities. The risks and rewards that arise from multi-employer schemes depend on the nature of the entity's participation in the plan and may be restricted depending on the participation arrangements. It would therefore seem that a user of financial statements needs equally to understand an entity's risks and rewards in relation to a multi-employer scheme as with other pension arrangements.

6.5 The third, and final, objective addresses funding obligations. The funding arrangements, particularly funding deficits, are arguably more complex for multi-employer plans than an entity's own plan. They often involve negotiation between all participating employers and the plan's management. Equally, therefore this objective seems to apply.

6.6 A review of the disclosure objectives for pension benefits suggests that the objectives are equally applicable to multi-employer plans. IAS 19⁷ does provide relief from disclosures where the information is not available, however, it requires that fact to be disclosed in the financial statements. Where information is not available then clearly this fact should be disclosed in the financial statements.

Entities with more than one plan

6.7 The disclosures set out in the Chapter until now assume entities have only one plan or arrangement. However, entities often have more than one arrangement – some of which may be subject to different regulatory regimes. At present paragraph 122 of IAS 19 notes that when an entity has more than one defined benefit plan, disclosures may be made in total, separately for each plan, or in such groupings as are considered to be the most useful.

6.8 The aggregation of information is conceptually difficult especially as the terms and conditions of the individual arrangements are likely to be different and subject to different legal and regulatory regimes. There are, however, alternatives to the current requirements of IAS 19, these include:

to require information to be provided in aggregate, and where individual schemes are material to the group as a whole to identify disclosure requirements for those particular plans;

to require information to be provided in aggregate, and to segregate plans into those plans that are in surplus to those that are in deficit.

6.9 **It was considered that in understanding the affect that pension assets and liabilities may have on an entity it would be helpful to be able to distinguish between deficits and surpluses which an entity is subject to. This analysis would provide a user of financial statements with useful information about the resources an entity has available to it.**

7 Costs and benefits

7.1 The analysis of disclosure requirements set out above, which are summarised in the appendix to this Chapter, provide what appears to be an exhaustive list of disclosure requirements and which some may consider excessive. It was noted however at the beginning of this Chapter that it was necessary to develop disclosures that focus on needs of investors, avoiding cumbersome disclosures.

⁷ Paragraph 29

7.2 It was also noted at the beginning of this Chapter that a concern regarding the extent of existing disclosure requirements for the provision of pension benefits had already been raised. In this context a question was raised regarding the relative merits of requiring an entity to provide extensive disclosures where its pension assets or liabilities are not material to its overall statement of financial position. That is, a general concern was expressed that disclosures needed to recognise the relevance (proportionately) of amounts. For this reason the appendix to the Chapter specifies the disclosures that should be provided where material and relevant.

7.3 The areas where additional disclosures are recommended in this Chapter in contrast to IAS 19/FRS 17 principally relate to providing greater disclosure about the risk of financial instruments held in connection with the investment strategies of a pension plan. These disclosures are adapted from IFRS 7 – although some may consider these disclosures excessive it is questionable why financial instruments held by a pension plan an employer sponsors should not be subject to the same disclosure requirements as those assets held directly by the entity.

7.4 The second area where disclosures are extended relates to funding and investment strategies. These disclosures respond to the concerns of users that financial statements should improve the quality of disclosures for pensions by requiring greater information about the risks and rewards an entity has in relation to liabilities to pay pensions. It might also be noted that SFAS 132 provides similar disclosure requirements for investment strategies and also requires disclosures regarding future contributions to the pension plan.

7.5 It would therefore seem that although this Discussion Paper recommends extending the disclosure requirements for pensions it does so having determined objectives for disclosures which have taken into consideration the concerns of the needs of users of financial statements.

8 Summary

8.1 This Chapter reviews the disclosures that it would be appropriate for an accounting standard to require.

8.2 Disclosures should provide information that explains the risks and rewards arising from the provision of pension benefits, having regard to the materiality of the amounts involved, such that:

- (a) financial statements contain adequate disclosure of the cost of providing pension benefits and any related gains, losses, assets and liabilities;
- (b) users of financial statements are able to obtain a clear view of the risks and rewards arising from liabilities to pay pension benefits and the assets held to fund those benefits; and
- (c) the funding obligations of the entity, in relation to liabilities to pay pension benefits, are clearly identified. (Section 2)

8.3 For practical reasons, an accounting standard would have to permit an employer to provide disclosure of information relating to its plans in aggregate; however, it would be reasonable to require separate information about surpluses and deficits. There is also a case for requiring specific disclosures for individual plans that are material to the group as a whole. (Paragraphs 6.7-6.9)

An Appendix to this Chapter provides a summary of the proposed disclosures.

Summary of proposed disclosures in the financial statements

Disclosures should provide information that explains the risks and rewards arising from the provision of pension benefits, having regard to the materiality of the amounts involved.

(An entity is required to provide only disclosures that are relevant to the provision of its pension arrangements).

Financial statements contain adequate disclosure of the cost of providing pension benefits and any related gains, losses, assets and liabilities

1. A reconciliation from the opening position for pension liabilities and the assets held to fund those liabilities to the closing position for pension liabilities and the assets held to fund those liabilities. The changes in assets and liabilities should be categorised according to the elements that give rise to the movements in those assets and liabilities.

2. As part of the reconciliation, or as a separate note, a reconciliation of total movement in the pension liabilities and the assets held to fund those liabilities to each of the primary financial statements. This disclosure should reconcile the surplus/deficit in the fund to the balance sheet position, and the total cost reported in the statement of comprehensive income.

3. The principal assumptions that are used to calculate pension liabilities as at the balance sheet date. This should include details of the:

- (i) discount rate;
- (ii) mortality rate – expressed at the number of years post retirement it is anticipated pension will be paid to members of the scheme;
- (iii) increases in salaries and general inflation; and
- (iv) any other material assumption.

Assumptions should be disclosed in a clear and effective manner.

4. A sensitivity analysis that shows the effect of changes in the principal assumptions used for the measurement of the pension liability. As an alternative a user may provide a value-at-risk or similar analysis to that of the sensitivity analysis.

5. Alternative measures of pension liabilities, where available. (As discussed in paragraphs 3.28-3.31, this may be in the management commentary).

Users of financial statements are able to obtain a clear view of the risks and rewards arising from liabilities to pay pension benefits and the assets held to fund those benefits

6. An entity should describe the nature of its liabilities arising from the provision of pensions to employees, this includes arrangements where the assets and liabilities are held in a separate plan.

7. The financial statements should disclose adequate information that enables the users of the financial statements to understand the relationship between the reporting entity and the trustees/(managers) a separate plan, fund or other arrangement. The information disclosed should allow the user to understand who controls the separate plan, and any 'unusual powers' vested in trustees/(plan managers).

8. The financial statements should provide information about the nature of the pension liability, including details of:

- active employees;
- deferred members; and
- pensioners.

9. The financial statements should disclose information that permits a user to understand the projected cash flows on which the present value of liabilities is estimated. This information can be presented in graphical form.

10. The financial statements should disclose information about the assets held to fund pension liabilities, this should include:

- (i) a description of the investment strategies, which gives rise to the allocation of assets held;
- (ii) an analysis of the assets held to fund pension liabilities by category, this shall include (but is not restricted to) equity instruments, debt, property; and
- (ii) where assets are not traded in active markets, details of the valuation technique used.

12. For each type of risk arising from financial instruments held to fund pension liabilities, an entity should disclose:

- (i) the exposure to risk and how they arise;
- (ii) the objectives, policies and processes undertaken by the pension plan or the entity for managing the risk and the methods used to measure the risk; and
- (iii) any changes in (a) and (b) from the previous period.

An entity may disclose a sensitivity analysis, such as value-at-risk, for types of risks to which a defined benefit scheme is exposed. Where an entity discloses such sensitivity analysis it should also disclose the

method and assumptions used in preparing this analysis and any changes from the previous period in the methods and assumptions used.

13. A narrative description of investment strategies including the expected return on assets and target allocation percentages or ranges of percentages for each major category of plan assets.

That the funding obligations of an entity, in relation to liabilities to pay pension benefits, are clearly identified.

14. A narrative assessment of how the liabilities for pensions will be met through the investment policies (return on assets) and the future contributions by the entity.

15. Agreements reached between trustees (managers) of defined benefit schemes and the reporting entity regarding not only agreed contributions but also regarding funding principles; and

16. Details of 'regular' and 'special' contributions where payable to a fund

Chapter 10: Accounting for multi-employer plans

1 Introduction

1.1 In the previous Chapters of this discussion paper accounting for individual pension plans is analysed. This Chapter focuses on the accounting for multi-employer plans. More specifically this Chapter is seeking answers to the question of whether and how to recognise and measure the individual employer's share in the collective net pension asset or liability of the multi-employer plan.

1.2 This Chapter does not address the accounting for group administration plans. For state plans where the benefit promise rests with the employer we expect similar principles to apply as for multi-employer plans, and accordingly the discussion in this Chapter is relevant.

1.3 For multi-employer plans that have the characteristics of defined benefit plans, IAS 19.29 requires the individual employers that participate in the plan to account for their proportionate share of assets and liabilities in the plan under the condition that sufficient information on the pension plan's assets and liabilities is available to the individual employer.

1.4 This requirement is being questioned in certain jurisdictions by employers participating in multi-employers plans, their auditors as well as by representatives of the multi-employer plans themselves. Many have argued that the outcome of the proportionate share of assets and liabilities of the fund is not a proper reflection of the actual liability of the individual participating employer. Many employers also have argued that from their perspective it would be questionable to classify multi-employer plans *de facto* as defined benefit plans when taking into account the governance of these plans.

2 Definition of multi-employer plans

2.1 IAS 19 provides the following characteristics of multi-employer plans:

- a pool of assets contributed by various entities that are not under common control.
- benefits are paid to employees of more than one entity on the basis that the contribution and benefit levels are determined without regard to the identity of the entity that employs the employees concerned.

2.2 These characteristics apply to a wide variety of multi-employer plans. In the European context they apply to plans in which only two employers collectively provide pension benefits to their employees, and also to plans in which all the (former) employers and employees of a whole industry sector (have to¹) participate.

¹ In certain countries employers are required by law to participate in these industry sector plans.

2.3 Examples of the second type, which sometimes also are referred to as industry plans, can be found amongst others in the United States, Sweden, The Netherlands and to a lesser extent in Germany. The main characteristics, next to the characteristics mentioned in the definition as provided in IAS 19, of these plans are:

- The bargaining parties (unions and associations of employers) negotiate a contribution rate and the board translates that rate into a benefit. Decisions to increase or decrease benefits or change the plan are made by the board of the plan and not by the participating individual employer.
- As a result of this indirect representation individual employers cannot exert any measurable influence on decisions made by the board.
- The size of the plan in terms of invested assets, pension obligations and number of participants is significant when compared with the total assets / liabilities or number of employees of the individual employers that are members of the plan.
- Stakeholders of the plan (employees, employers and pensioners) are only indirectly represented in the board of the plan by their unions, associations of employers and pensioner representatives.

2.4 In some countries an additional distinctive characteristic is present for certain industry and or state plans:

- The obligation to pay contributions is directly linked to the current wages of active employees that participate in the pension plan. There is no direct obligation to pay contributions for former employees. An individual employer can technically “walk away” from its obligation by leaving the industry and releasing the employees that are participants in the plan.

3 Recognition and measurement

Recognition

3.1 According to IAS 19, multi-employer plans are classified (defined benefit or defined contribution) and accounted for in the same way as single employer plans, considering the characteristics of the plan and the obligation of the employer. For multi-employer plans that are characterised as defined benefit plans this means that the participating individual company has to recognise its proportionate share of the plan’s pension asset or liability.

3.2 Characterisation as either defined benefit or defined contribution under IFRS follows the strict definitions provided in IAS 19. Defined contribution plans in this context are defined as plans for which the employer has no legal or constructive obligation to pay further contributions if the fund does not hold

sufficient assets. By using these definitions many multi-employer plans qualify as defined benefit plans.

3.3 Unlike IFRS, US GAAP does not require an employer to account for its proportionate share of the assets, liabilities and costs of a defined benefit multi-employer plan, but allows the employer to recognise as net pension cost only the required contribution for the period.

3.4 Conceptually there seems to be no reason to create a scope exception for the accounting of multi-employer plans as currently applicable in US GAAP. Furthermore, the introduction of scope exceptions seems to go against the overall objective of contributing to the development of principles-based standards on the financial reporting of pensions. **The recognition principles as set out in previous Chapters of this paper should therefore also apply in relation to multi-employer plans.**

4 Multi-employer plan's assets and liabilities –reporting entities

4.1 As explained in Chapter 3 of this paper, liabilities to pay pension benefits could be:

- liabilities of the employer (in the *individual* financial statements);
- liabilities of another entity (e.g. a separate pension provider or an employer-sponsored trust);
- liabilities of the employer's group – (in the *consolidated* financial statements – if they were liabilities of another entity that was accounted for as if it were a subsidiary of the employer).

Similarly, assets held to pay benefits could be:

- assets of the employer (in the individual financial statements);
- assets of another entity (e.g. a separate pension provider or an employer-sponsored trust);
- assets of the employer's group – (in the employer's consolidated financial statements – if they were assets of another entity that was accounted for as if it were a subsidiary of the employer).

4.2 For multi-employer plans in most cases the employers have the obligation to make contributions to the plan. The plan has the obligation to pay pension benefits to the members of the plan when they become entitled to these benefits. The rights and obligations of the different parties appear to be as set out in the following table. This table has many similarities with the table provided in Chapter 3 which shows the rights and obligations in respect of a single-employer plan when assets and liabilities are held in a separate trust and the employer has an obligation to support the trust.

The financial reporting of pensions

	Assets	Liabilities
<i>Members</i>	Claim against the multi-employer plan for right to receive pension benefits (A)	
<i>Multi-employer plan</i>	Assets invested Right to call for contributions from the participating employers to the extent that the plan's obligations cannot be met from its own assets (B)	Obligation to plan members to pay their benefits (A) <i>Possibly</i> , an obligation to return a surplus to the participating employers, to the extent that the plan's own assets exceed its obligations (C)
<i>Employing entity</i>	<i>Possibly</i> , a right to call for a return of its share of surplus from the plan to the extent that the plan's own assets exceed its obligations (C)	A share of the participating employers' obligation to the plan to the extent that the plan's obligations cannot be met from its own assets (B),

4.3 For certain multi-employer plans (mostly industry plans), the employer may have the opportunity to “walk away” from future obligations by leaving the industry and without incurring any further obligations. In these cases it could be reasoned that the obligating event is participation in the multi-employer plan during the reporting period and that the employer's obligation at any point in time would be limited to the current contributions payable.

4.4 This approach has similarities with the approach as outlined in IFRIC Interpretation 6 ‘Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment’. According to this interpretation, participation in the market during the measurement period is the obligating event in accordance with paragraph 14(a) of IAS 37. As a consequence, a liability for waste management costs for historical household equipment does not arise as the products are manufactured or sold. Because the obligation for historical household equipment is linked to participation in the market during the measurement period, rather than to production or sale of the items to be disposed of, there is no obligation unless and until a market share exists during the measurement period. The timing of the obligating event may also be independent of the particular period in which the activities to perform the waste management are undertaken and the related costs incurred.

4.5 However, on the other hand it could be argued that on a macro-economic scale it is highly unlikely that all participating employers will be able to “walk away” from their collective obligation. Therefore, in order to conclude that an individual employer is able to walk away from its obligation also these macro-economic factors need to be taken into account.

5 Measurement of the multi-employer plan's assets and liabilities

5.1 The views on measurement of pension assets and liabilities set out in Chapters 5-7 and 11 of this paper seem equally applicable to multi-employer plans. From a theoretical perspective there does not seem to be a convincing argument to allow a different set of measurement principles for multi-employer plans. However, from a more practical perspective, some have questioned whether it is reasonable to require multi-employer plans to provide some of the individual employers with the necessary information to calculate their proportionate share in the plan's asset / liability. This would probably increase the administrative burden of the fund especially when the plan is accounting under a different set of accounting principles than IFRS. It furthermore has to be noted that the information requirements are not similar for every individual employer. These requirements may be different depending on the accounting principles applied by the employer as well as on potential regulatory requirements. For these reasons, for some industry and state plans it has proven to be fairly difficult to obtain the required information from the multi-employer plans.

5.2 Furthermore the funds seem to have difficulties providing the necessary data on time (before the reporting date of the individual employers). Additionally it has become clear that individual employers, due to the governance structure of many pension funds, do not have the authority to demand the required information.

6 Measurement of the employing entity's pension related assets and liabilities

6.1 In accordance with IAS 19.32; where sufficient information is available about a multi-employer plan which is a defined benefit plan, an entity accounts for its proportionate share of the defined benefit obligation, plan assets and post-employment benefit cost associated with the plan in the same way as for any other defined benefit plan ².

6.2 This requirement justifies raising the question whether accounting for the proportionate share of assets and liabilities provides a proper reflection of the individual participating employer's share in the difference between the multi-employer plan's assets and obligations.

6.3 There are a number of complicating factors that could impair a proper reflection of the pension related assets and liabilities of the individual participating employer. The first complicating factor is the fact that, to allocate parts of the total plan assets and pension liabilities of the fund, an allocation key has

2 However, in some cases, an entity may not be able to identify its share of the underlying financial position and performance of the plan with sufficient reliability for accounting purposes. This may occur if:

- (a) the entity does not have access to information about the plan that satisfies the requirements of the standard; or
- (b) the plan exposes the participating entities to actuarial risks associated with the current and former employees of other entities, with the result that there is no consistent and reliable basis for allocating the obligation, plan assets and cost to individual entities participating in the plan. In those cases, an entity accounts for the plan as if it were a defined contribution plan and discloses additional information.

to be used. One can think of many allocation keys such as number of employees, wage bill etc. However, all these keys cannot take fully into account the fact that the liability is not so much related to the actual number of employees or payroll expenses of the individual employer but is rather related to the build up of the entire fund. By definition, in a multi-employer plan risks typically are shared by all those involved. Those involved change constantly as new employers enter and others leave. The outcome of any allocation key would therefore always be an average of the net asset / liability, which potentially does not fully provide information on the liability on an individual employer's basis. It becomes even more difficult when one tries to allocate a net asset of the fund to the individual employers. Some believe that due to these complicating factors it would be better not to recognise an asset or liability in the individual employer balance sheet related to the multi-employer plan but only to recognise the contributions payable.

6.4 Some others believe that even when an allocation key could be determined the result would not be a reflection of the individual employer's liability towards the fund and therefore no asset or liability related to the multi-employer plan should be recognised. Those who support this view have reasoned that there is a difference between the current pension asset or liability of the multi employer plan in accordance with IAS 19 and the future funding by the collective of (future) employers and employees. In their view, this is demonstrated by the following:

- The board of the plan, when determining future contribution / funding requirements, is reviewing a pension asset / liability that is calculated on the basis of information and assumptions that in many cases is different from those applied in IFRS.
- The pension asset / liability of the plan is not a static amount that cannot be controlled by the board of the plan. Next to requiring funding from participating employers the board can manage the liability by changing employees' contributions, the indexation of the pension benefits or the nature of certain other benefits. Changing these elements would also directly impact future contributions by the individual employers.
- In many collective bargaining agreements the employer and employee contributions are capped for a certain period of time and can only move between pre-set limits. This may also indicate that there is a difference between the current asset / liability in accordance with IFRS and the actual future funding. Furthermore, it is claimed that multi-employer plans are not open ended from a contribution perspective because, in the event of major shortages in the fund, many funds have decreased benefits instead of increasing contributions. This at least provides some indication that under-funding does not automatically have to result in contribution increases but could also lead to benefit decreases. The latter demonstrates that a part of the risk of underfunding lies with the employees and pensioners and not with the employers³ and that the pension asset and liability is not a static amount that cannot be (at least partially) be controlled.

³ It should also be noted that for many industry plans the effect of pension contribution increases on the plan assets is fairly limited due to the fact that a majority of the fund's participants are inactive (e.g. no longer employed in the industry). Changing contribution levels is therefore in many cases considered to be rather ineffective for managing underfunding.

6.5 It may be noted, however, that many of the examples provided could also apply in situations where an individual employer is sponsoring a separate plan. Recent history has shown that, in the case of single-employer plans, the pension asset / liability is sometimes managed in more ways than only by changing the employer's contributions. Where this occurs, it may be argued that contributions by the sponsor are to a certain extent capped and that the risk of underfunding also lies with the employees and pensioners. In this respect multi-employer plans appear to have similar characteristics to single-employer plans and it seems reasonable to take the view that the same principles for the recognition and measurement of the pension asset / liability should apply for both single and multi-employer plans.

7 Reflect the individual employer's obligation to the multi-employer plan

7.1 The first step in measuring the individual employer's obligation to the multi-employer plan is the determination of the total pension asset / liability of the multi-employer plan as a whole. As discussed in paragraph 10.17 of this Chapter it was concluded that the same measurement principles for this pension asset / liability should apply as for individual plans.

7.2 In Chapter 5 the view is put forward that a current value measure of a liability in respect of future pensions will be a 'settlement amount', reflecting a measure of the cash outflows (or other transfers of economic benefits) needed now or in the future to discharge the liability. It is also suggested that if alternative means of settling a liability are currently available to an entity (i.e. it is within the employer's control to achieve them), the liability should be reported at the lowest amount of the available alternatives.

7.3 If a multi-employer plan is in deficit, the principal means by which an employer could settle its obligation seem to be:

- buy-out (i.e. an immediate payment to the plan to discharge the liability), or
- payment of contributions required for continuing participation.

In many situations, there may be no possibility of settling the liability currently.

7.4 In a single-employer plan, Chapter 7 suggests that an employer's liability in respect of a deficit (or asset in respect of a surplus) should be based on the difference between the current value of the plan's liability to pay benefits and the current value of its assets. This basis reflects both the expected contributions that the employer will be required to pay and the employer's constructive obligation to the plan if the plan's assets do not perform as expected.

7.5 In a multi-employer plan, an equivalent settlement amount would reflect the expected future cash-flows of the individual employer to the multi-employer plan for settling its obligation for its former and current employees that participate(d) in the plan and its constructive obligation in respect of its share in the current under- or over-funding of the plan. Unlike a single-employer plan, the latter would reflect

additional risks that an employer takes in relation to the actions of other participating employers. However, individual employers or multi-employer plans in most cases do not have all the information available to determine a settlement amount on this basis. As a result, it seems necessary to consider, as a surrogate for a settlement amount, an allocation of a deficit or surplus in the plan to determine individual employers' proportionate shares.

7.6 This requires identifying an allocation key. We discussed several allocation keys and concluded that probably it would be preferable to use a key that is related to the basis that is also used for determining the pension contribution. This basis would, in many cases, be related to the pensionable salary of the active employees. In this event the allocation key would be the pensionable salary of the individual employer divided by the total pensionable salary of all the participation employers. By multiplying this key with the total pension asset / liability the proportionate share of the individual employer can be determined.

7.7 The periodic change in the employer's share of the multi-employer plan's total asset / liability should be classified as a separate line item in the profit & loss account similar to actuarial gains and losses whereas the pension contribution payable could be classified as employee compensation expenses.

7.8 Although it is agreed that the outcome of the approach described above is not perfect and also not necessarily the same as individual employer's future cash-flows related to its participation in the fund, in absence of better alternatives, it is probably the best alternative available to date.

8 Reflect only recovery plans or asset refund plans

8.1 Some believe that, in absence of a "reliable" method for measuring the individual employer's share in the multi-employer plan net asset / liability, no asset or liability should be recorded except for the current pension contributions payable and potentially any additional liabilities resulting from recovery plans implemented by the multi-employer plan⁴. We believe that this third alternative should only be used in the rare event that the individual employer is unable to obtain the required information from the multi-employer plan. This situation could potentially occur for certain state plans and large multi employer plans that have the characteristics of state plans.

⁴ The recording of a liability for recovery plans follows the guidance in IAS 19.32A and IAS 19.32B which states that the guidance in IAS 37 "Provisions, Contingent Liabilities and Contingent assets" should be applied. Following this guidance an additional asset or liability has to be recorded in the event that the board of the plan has agreed to a recovery plan that includes future pension premium increases or a surplus distribution plans that includes premium discounts or refunds (partly) to the individual employers.

9 Summary

9.1 The recognition and measurement principles as set out in Chapters 4-7 of this paper should also apply in relation to multi-employer plans. Accordingly, the pension liability of an individual employer will be a 'settlement amount' reflecting its expected future cash-flows to the plan for settling its obligation for its former and current employees and any constructive obligation in respect of its share in the current under- or over-funding of the plan.

9.2 The following alternative approaches are considered as a surrogate for a settlement amount.

- Proportionate share of collective pension asset or liability
- Reflect only the effect of recovery plans or asset refund plans
- Do not account for the employer's rights and obligations in respect of under- or over-funding.

9.3 The following table provides an overview of the alternatives together with our main observations:

Preference of measurement method	Measurement Method	Comments on method
Most	<i>Settlement amount</i>	<ul style="list-style-type: none"> • <i>Information on settlement amount needs to be obtained from multi-employer plan. To obtain this information from the plan may be challenging.</i> • <i>For plans where the individual employer can “walk away” from its obligation the settlement amount would be equal to current pension contribution payable.</i>
	<i>Proportionate share in collective net pension asset / liability of the multi-employer plan</i>	<ul style="list-style-type: none"> • <i>To calculate the individual employer’s share in the plan a calculation needs to be obtained from multi-employer plan as well as an allocation key. To obtain this information on a timely basis may be difficult. However the resources needed to calculate collective net pension asset / liability is probably less than those needed to calculate individual settlement amounts.</i>
	<i>Recording of pension asset / liability only to reflect the effects on the individual employers of recovery plans or asset refund plans</i>	<ul style="list-style-type: none"> • <i>Also for this approach information from the multi-employer plan needs to be obtained. However, the resources needed to provide this information to the individual employers seems to be less than for the previous two alternatives.</i> • <i>Only a limited part of the pension liability of the individual employer would be reflected in the employer’s balance sheet.</i>
Least	<i>No individual pension liability.</i>	<ul style="list-style-type: none"> • <i>There seems to be no theoretical basis for this approach.</i> • <i>This alternative should only be used in the rare event that no information is available to calculate the settlement amount or the employer’s proportionate share.</i>

Chapter 11: Financial reporting by pension plans

1 Introduction

1.1 Previous Chapters of this Discussion Paper have in the main addressed the financial reporting by employers. Although pension plans were mentioned, the main considerations related to the employer's financial statements. This Chapter addresses the financial reporting by pension plans.

2 Why is financial reporting by pension plans important?

2.1 For many individuals an interest in a pension plan is one of their most valuable assets, and so members of pension plans are naturally interested in the plan's financial affairs. Members cannot necessarily derive all the information they require from the employer's financial statements. For instance, information on several pension plans may be aggregated in the employer's financial statements, whilst the member needs information on the specific plan of which he is a member. It is also possible that members require different information than that which is provided in the employer's financial statements, which are primarily intended to serve the needs of investors in the employer.

2.2 The financial reports of pension plans are therefore important, and good financial reporting by pension plans can be expected to contribute to confidence in pension plans. However, financial reporting requirements for pension plans have often been greatly influenced by regulatory requirements. As has been noted elsewhere in this paper, regulators have as one of their prime concerns the solvency of pension arrangements and information that is suitable for monitoring solvency is not necessarily the same as that which provides the fullest financial information from an accounting perspective.

2.3 Perhaps because of the dominance of regulatory requirements, accounting standard-setters may not always have devoted adequate time and resources to the financial reporting of pension plans. But nonetheless good reporting by pension plans is important to members and to economies in which pension plans are significant. The accounting profession, and standard-setters in particular, should consider whether they have a contribution to make.

3 A standard for financial reporting by pension plans?

3.1 Pension plans may be required to prepare various reports for different purposes—reporting to regulators, members and so on. This Chapter, however, discusses standards that would focus on the general purpose financial reports that a plan might be required to prepare rather than these other specific kinds of reports. We also note that narrative reporting is potentially of great value in reporting the financial position of a pension plan and standard-setters have addressed this topic, for example, in IASB's Discussion Paper on Management Commentary. Accordingly this Chapter considers information that might be conveyed either in the general purpose financial statements or elsewhere in the annual report.

3.2 Financial reporting is converging on a single set of standards promulgated by IASB ('IFRS'). Because IFRS will shape the expectations of those who read and use financial reports, it would be regrettable if the financial reports for pension plans were to be drawn up in accordance with different principles from those used by the IASB for other entities.

3.3 There is already an international standard, IAS 26 'Accounting and Reporting by Retirement Benefit Plans'. IAS 26 is now twenty years old, and it seems reasonable to question whether it reflects current accounting thinking. In particular, it contains a number of options on whether the liability for future benefits is presented in financial statements, and whether the liability is to be calculated on present or projected salary levels.

3.4 There is therefore a strong case for reconsidering the requirements of IAS 26. A replacement international standard, setting out appropriate requirements for the financial reporting of pension plans would be helpful to those responsible for the regulation of pension plans and would have the advantage of ensuring that the requirements were consistent globally.

3.5 It may be, however, that other priorities of the IASB will prevent it from devoting the necessary resources to developing a replacement standard. Nonetheless, the existence of IAS 26 provides an obstacle to jurisdictions wishing to develop more rigorous and up-to-date guidance. IASB should therefore consider withdrawing the current IAS 26 even if it is not able to develop a replacement at this time.

3.6 The financial statements of pension plans are likely to have many issues that need specific consideration or interpretation. So it may not be feasible simply to require the observance of IFRS in total. Nevertheless, the financial reporting for pension plans should be consistent with IFRS, and there should be a specific requirement to observe IFRS where an issue is not otherwise addressed.

3.7 In the light of the foregoing discussion, it is proposed that:

IASB should consider withdrawing IAS 26 'Accounting and reporting by retirement benefit plans'. Requirements for the general purpose financial reports of pension plans should be consistent with IFRS.

3.8 Most of the remainder of this Chapter discusses what such requirements might be. However, to put that discussion in context, the next section addresses the objective of the financial reports of pension plans.

4 The objective of financial reports of pension plans

4.1 The objective of financial statements as set out in the IASB's current 'Framework for the Preparation and Presentation of Financial Statements' is:

to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions (IASB: Framework, paragraph 12)

4.2 In the IASB's July 2006 Discussion Paper 'Preliminary Views on an improved Conceptual Framework for Financial Reporting' the following objective is proposed:

The objective of general purpose financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource allocation decisions (paragraph OB2)

4.3 These objectives should be suitable as the basis for a standard on pension plan accounts. However, it is perhaps useful to emphasise two points that appear to be particularly relevant in this context. These are:

- the importance of stewardship in the objective of financial reports; and
- the users of the financial reports.

Stewardship

4.4 Currently, as part of the IASB/FASB project to revise their Frameworks, the balance between 'decision usefulness' and stewardship in the objective of financial statements is being debated. It seems to be generally accepted that, although the draft objectives refer explicitly only to decision usefulness, this does not exclude information that is needed to assess stewardship (or 'accountability').

4.5 Although members of a pension plan may be able to make some decisions in respect of their pensions—they may, for example, elect to transfer their pensions or to pay additional contributions, typically the scope for decision-making by members of pension plans is limited. On the other hand, pension plans hold assets on behalf of their members and are (or ought to be) accountable to members for their deployment and return. It therefore seems that the idea of accountability (or stewardship) is a necessary part of the objective of the financial reports of pension plans. One of the key needs of members of a pension plan is to be able to assess the security of their benefits and their likely timing and amounts:¹ Although that assessment may sometimes influence economic decisions taken by the members, it is more direct to be clear that providing information that is useful for such an assessment is an objective of financial reports.

¹ In the USA, Statement of Financial Accounting Standards No. 35 (SFAS 35) 'Accounting and Reporting by Defined Benefit Pension Plans' specifies that the primary objective of a pension plan's financial statements is "to provide financial information that is useful in assessing the plan's present and future ability to pay benefits when due" (paragraph 5)

The financial reporting of pensions

The primary user of pension plan reports

4.6 The discussion above has assumed that the members of pension plans are amongst the main users of the financial reports provided by plans. We now need to review who the users of pension plan reports are, and what their needs are. The table below sets out some of the users of pension plan financial reports and their needs:

Users	Requirements
Active and deferred members, pensioners and other beneficiaries	Security, timing and amount of benefits. Investment returns and strategies
Members' advisers and representatives, including trade unions	As for members, but possibly with greater detail.
Trustees	To demonstrate the financial consequences of actions taken by the Board of Trustees in governing the plan and their stewardship of the funds.
Governments and regulators	To oversee and regulate pensions in order that the industry portrays confidence and financial stability – economic impact of pensions is regulated.
Employers	Interested in financial position of the plan as it will affect funding and contribution levels – has direct effect on the economic resources available to an entity.

4.7 It may be noted that, with the exception of members and their advisers, all of the users in the table above will normally be able to secure whatever information they wish concerning the financial position and affairs of the plan. This suggests that general purpose financial reports should focus on the needs of members. This is not, of course, to deny that the other users may find the general financial reports useful and be keenly interested in them, but only to point out that these reports are not produced primarily for the benefit of such users.

4.8 The conclusion that financial reports of pension plans should primarily focus on the members may seem questionable, given the evidence² that members of pension plans rarely request copies of the plan's financial statements and, perhaps, would be challenged to understand them in many cases. However, this overlooks the role of their representatives (including trade unions) and other financial advisers. They will want to study the pension plan's financial report closely and will find it most useful if it is prepared from the perspective of the member, since their role is to act in the members' interests and to advise members on their pension affairs. For this reason, the role of employee representatives and advisers requires special emphasis.

Defined benefit and defined contribution plans

4.9 Earlier in this paper it was noted that existing standards for pensions draw a sharp distinction between defined contribution and defined benefit plans. This paper seeks to avoid relying on that distinction. It may, however, be questioned whether a single objective is appropriate for both types of plans. IAS 26, for example, states slightly different objectives for them (in paragraphs 16 and 22, respectively).

4.10 It may be suggested that members in a defined contribution plan are at greater risk than those in a defined benefit plan from investment performance: conversely, if members of defined benefit plans are less exposed to investment risk information on the employer's covenant is of the most significance for them.

4.11 Obviously there is no role for information on an employer's covenant if there isn't one, as would be usual in a defined contribution plan. In a defined contribution plan there is no uncertainty about the amount of its liability for future benefits, which will be the same as the amount of its assets.

4.12 But it is not necessarily correct to say that a member of a defined benefit plan is not interested at all in the investment performance. After all, even in a defined benefit plan, a member's claim is still primarily on the plan. It is more secure the greater the amount of funds available to pay benefits. As has been noted one of the common reasons for setting up a separate entity is to isolate the assets used to pay benefits from the commercial hazards to which the employer is subject. There is also, in some circumstances, a possibility that a member may receive improved benefits in the event of a surplus.

² Evidence from the UK is given in The Pension Regulator's Discussion Paper 'A review of the form and content of pension scheme report and accounts' (June 2006) and 'A review of the form and content of pension scheme report and accounts: The regulator's response' (November 2006).

4.13 In the light of the foregoing it is concluded that a single objective is relevant for all plans. For the purpose of this Chapter, the following objective is proposed.

The objective of the financial reports of a pension plan is to provide information about the financial position, performance and changes in financial position of a pension plan that is useful to members and those who act in their interests, in making economic decisions and assessing the stewardship of the trustees.

4.14 This objective is that financial reports will provide information that is useful in assessing the plan's present and future ability to pay benefits when due. It includes specific reference to 'those who act in the interests' of members, so that information that only a professional can understand is included. Because the objective includes stewardship, pension plan reports should make trustees accountable to members, and explain the strategies adopted by the trustees and report on their outcomes.

5 Assets available to pay benefits

5.1 Most (perhaps often all) of the assets of a pension plan will consist of investments that are held in order to provide the funds to pay benefits. IAS 26.32 requires these investments to be stated at fair value, which is market value in the case of marketable securities.

5.2 The valuation of these assets was discussed in Chapter 6, the conclusions of which are consistent with the requirements of IAS 26. (The only significant difference would appear to be that IAS 26 makes explicit allowance for cases where a fair value cannot be obtained.) The conclusions of that Chapter are equally applicable to the financial reports of pension plans and are reproduced below:

- (a) Reporting assets held to pay benefits at current value provides more useful information than reporting them at historical measures. This is consistent with the views presented on measuring liabilities to pay benefits.
- (b) The present requirement in pensions accounting standards that assets traded in active markets are measured at market prices is well founded.
- (c) The role of investment strategy in meeting obligations to pay benefits requires disclosure and explanation (rather than recognition) in financial statements.
- (d) When an asset is not traded in an active market, a market-based value should be estimated using a valuation technique in accordance with the guidance in other accounting standards. It is important that the supporting disclosures about such assets convey information about the valuation techniques that have been used and the nature and extent of the risks arising and, in this regard, that users are made aware of the relative liquidity of alternative investments (that is, investments other than financial instruments that are traded on recognised exchanges).

5.3 These conclusions may be summarised as follows:

Assets available to pay benefits should be stated at current value, which is market value where the asset is traded on a market.

6 Liabilities to pay benefits

6.1 The most striking divergence of the financial statements of pension plans from generally accepted practice is in the treatment of liabilities for benefits payable in the future. IAS 26 requires a plan to prepare a statement of net assets available for benefits, and permits three options in respect of the actuarial present value of promised retirement benefits.

- (a) it may be incorporated in the net asset statement, which therefore shows a resulting surplus or deficit;
- (b) it may not be reported in the net asset statement but disclosed in a note to that statement;
- (c) it may be neither recognised nor disclosed in a note to the statement of net assets available for benefits.

6.2 A separate actuarial report is required where a plan chooses option (c); otherwise presentation of such a report is optional. Thus some form of disclosure of the actuarial present value of promised retirement benefits is required either in the financial statements or in an accompanying report. The value of this, however, is diminished as IAS 26 contains few specific requirements for the calculation of the actuarial present value and specifically permits it to be based either on current or on projected salary levels (paragraph 23).

6.3 This gives rise to three questions, which are addressed separately below:

- (i) Should a standard require a liability for benefits payable in the future to be included in a plan's primary financial statements?
- (ii) Is the plan's liability the same as the employer's?
- (iii) How should the plan's liability for benefits payable in the future be measured?

Should pension plans' financial statements include a liability for benefits payable in the future?

6.4 In earlier parts of this paper the relative position of the employer and a pension plan has been analysed in some detail. The discussion noted that, in many situations which arise quite commonly, the primary liability to pay future benefits rested not with the employer, but with the plan. It might seem to be self-evident that, where this is the case, the plan should report a liability.³

6.5 However, it is clear that a proposal to include in the financial statements of pension plans a liability for future benefits is likely to be controversial particularly in those jurisdictions, such as the UK, where it would be a significant change from present practice (although it is required in many other jurisdictions). The arguments therefore merit close attention.

6.6 If a plan's statement of financial position omits a significant liability—and generally the obligation to pay benefits in the future will be significant—then it is very questionable whether the financial statements can be said to give a fair presentation of the plan's financial affairs. It was noted above that one of the objectives of a plan's financial statements was to enable an assessment to be made of the trustees' stewardship of the plan, but it would seem impossible to achieve this if significant liabilities are excluded. For example, if a plan accepts a transfer of members its financial statements will report the increase in its assets, but not the effect of the transfer on the plan's liabilities. It is doubtful whether such incomplete information could be regarded as satisfactory even if the basis for its preparation was fully disclosed.

6.7 One of the grounds for opposing reporting a liability for future benefits is that it might be confusing to members. One reason for this is that liabilities might be quantified in different ways for different purposes and members may demand to know what the 'right' number is. Another possible source of confusion is that it might tend to imply that the plan is insolvent when this is not the case. However, the purpose of the financial statements is to report the financial position at a specific point in time, not to point unambiguously to further outcomes. Under present requirements some plans report alternative measures of the liability (and surplus deficit) to their members and explain the significance of each. It is to be expected that those who represent pension plan members or who provide financial advice to them will understand the significance of the amounts reported.

6.8 Another reason for objecting to the inclusion in a plan's financial statements is the cost of doing so. However, it would appear that the most significant additional cost is likely to be that of audit: against such costs the benefit of additional credibility in the financial statements would have to be weighed. Experience from Australia suggests that the incremental costs may be much lower than had been feared by many.

³ It was also noted above that there are some arrangements where the primary liability rests with the employer, who is entitled to be reimbursed by the pension plan. The following discussion is equally applicable to such arrangements, where the plan's liability is to the employer rather than to the member.

6.9 The arguments against the inclusion in a plan's financial statements of a liability to pay future benefits do not seem to be convincing. Accordingly it is proposed that:

The standard should require a pension plan's financial statements to include the liability to pay future pensions.

Is the plan's liability the same as the employer's?

6.10 In Chapter 2 of this paper, the components of the liability that arises in from a promise to pay pensions are discussed at length. The discussion may have tended to focus on the position of the employer. In the main, however, the conclusions of that Chapter seem equally applicable to the position of the plan.

6.11 The only issue that seems to merit further comment is whether the *plan* has a liability in respect of decisions that are within the *employer's* discretion (or, at least, some might consider that the employer has discretion). The point arises mainly in respect of the effect of future salary increases. We noted in Chapter 2 that views are divided as to whether the liability should reflect future salary increases, where these affect the amount of the benefit to be paid. As noted above, IAS 26 permits a plan to calculate and report its liability using either current or projected salary levels.

6.12 It would seem possible to maintain that whilst the *employer's* liability should reflect future salary increases that of the *plan* should not: on this view a plan's liability increases only when a salary increase is awarded. IAS 26 notes this argument in favour of a current salary approach, and also that a current salary calculation is more objective, and more closely related to the amount payable in the event of termination or discontinuance. However, it seems contradictory to hold that the employer's liability includes a factor that the plan's does not, especially as the plan stands ready to accept the totality of liability.

6.13 Thus it is proposed that:

The components of a plan's liability should be the same as those identified in Chapter 3.

How should the plan's liability be measured?

6.14 IAS 26 is clear that a plan's liability should be quantified as an actuarial valuation, and this is probably the basis that is most widely used in practice. Although IAS 26 does not specify further what an actuarial valuation involves, the term would seem to include methods that discount liabilities at the rate that the plan's investments are expected to return.

6.15 In Chapter 5 various bases for the measurement of pension liabilities were discussed. It was concluded that, in most cases, a run-off amount would be the basis to be used, and methods that take account of the return on assets were rejected. That discussion is equally applicable to the liability of a plan.

6.16 Regulatory measures (including technical provisions in the EU) were considered in Chapter 5 as a possible means of quantifying the liability. It was noted that these are actuarial calculations, are concerned primarily to secure adequacy of funding, and do not correspond to measures based on accounting principles. They reflect, amongst other things, the strength of the employer's covenant. It might, however, be argued that regulatory measures should be used for the financial statements of a plan, since it is the prime duty of trustees to secure adequate funding (as defined by the regulatory environment), and it is against this target that their stewardship should be assessed.

6.17 This cannot, however, be accepted. It is true that a regulatory measure is used to monitor the compliance of a pension plan with funding requirements and that, if they are not met, action may be taken against the employer and/or the trustees. But the responsibility of the trustees is wider than simply that of securing funding that complies with whatever regulation the plan is subject to: they are responsible for the totality of the plan's financial affairs and should be accountable to members and other beneficiaries in respect of them. Funding requirements are obviously relevant to the work of the trustees, but it would be anomalous if changes in the regulatory requirements (or an employer's covenant) impacted on the plan's reported liability to pay pensions.

6.18 Thus this paper proposes that:

A plan's liability in respect of future pensions should be measured according to the principles identified in Chapter 5 above.

6.19 This proposal, however, does not necessarily imply that the plan's liability will be identical to that of the employer. The management of each entity is responsible for that entity's financial statements. It is not inevitable that the assumptions adopted by the trustees or managers of the plan will be identical to those adopted by the employer. To the extent that the assumptions differ, so will the reported liability. It might be expected, however, that in many cases, the employer and the plan managers will adopt similar assumptions, as they have, for example, to reach agreement on contribution levels.

7 The employer's covenant

7.1 If the above proposals are accepted, a consequence would seem to be that, in many cases, a plan's reported liability would exceed its assets, giving rise to an apparent deficiency. However, where an employer has undertaken or is required to ensure that the plan is able to pay the promised benefits the apparent deficiency might be explained by the fact that this undertaking is not reflected in the plan's financial statements, which are therefore misleading. It is therefore necessary to consider how that undertaking should be reflected in the plan's financial statements.

7.2 Where the employer and the plan have agreed that a shortfall will be addressed by the employer making specified payments over and above its regular contributions, and that agreement is enforceable, then it should be recognised in the plan's financial statements as any other financial asset, at an amount

reflecting both the time value of money and credit risk.⁴ Such an agreement is often intended to address a shortfall in funding, and there will, in many cases remain over and above such agreed amounts the employer's general responsibility or undertaking to ensure that promised benefits are paid. This is referred to as 'the employer's covenant'.

7.3 Under current accounting standards, the employer's covenant might in some cases be regarded, from the plan's perspective, as a contingent asset. Amounts will only be receivable in the event that the plan cannot pay the promised benefits, and there may be good grounds (even if there is currently an apparent deficit on an accounting basis) to believe that this is not probable. Applying the requirements of the current IAS 37 'Provisions, contingent liabilities and contingent assets' to this analysis would suggest that no asset should be recognised.⁵ Some would consider that this is the most practicable approach and, given adequate disclosure of the position in the notes to the financial statements, would provide suitable information as to the extent of the employer's covenant.

7.4 Another possible approach would be to require the current value of the employer's covenant to be estimated. This would be a measure that attempted to quantify the amount and timing of future cash flows likely to arise under the covenant, probably using an expected value calculated under a number of scenarios. This would clearly be a burdensome and highly subjective calculation to perform. It is also open to the objection, in principle, that it would seem that it would inevitably take account of future investment returns. The point is similar to the quantification of the employer's liability by reference to expected cash flow, which was rejected in Chapter 7.

7.5 A simpler approach would be to require that where (and to the extent that) an employer has undertaken to make payments to a plan to enable it to pay future benefits, then the plan should recognise an asset, based on the difference between the amount of its liability and the value of its assets available to pay those benefits. This would, of course, need to be presented clearly and separately from the plan's investments.

7.6 Chapter 7 concluded that, where an employer's obligations were represented by a net obligation, being the difference between the settlement amount of the liabilities and the market value of the assets, then it should report a net position based on the difference between those amounts. Where and to the extent that an employer recognises a liability in respect of this, it would seem entirely appropriate, in principle, for the plan to report a corresponding asset. Because the calculation of this asset is essentially

⁴ Similarly, a plan may report a liability in respect of a surplus, where it has little or no discretion to avoid making a refund to the employer or to accept a reduction in future contributions so that they would not be commensurate with the benefits arising.

⁵ The Exposure Draft of proposed amendments to IAS 37 proposes that contingent assets should no longer be dealt with by that standard. The Basis for Conclusions in the Exposure Draft noted that some categories of items previously treated as contingent assets might in future fall within the scope of IAS 38 'Intangible Assets'. However, it seems that, as the employer's undertaking would be a financial asset from the perspective of the plan, it would be accounted for under IAS 39.

the same as that done for accounting by the employer (subject to the possibility of different assumptions being used, as referred to in paragraph 6.19 above), this proposal would seem relatively easy to implement and should not give rise to significant additional costs.

7.7 It was concluded above (in Chapter 5) that it was inappropriate for an employer's liability for pensions to be reduced to reflect the employer's own credit risk. From the perspective of the plan, however, it would seem wrong in principle to report an asset without having regard to the credit risk to which it is subject. This is a general point that applies to all financial assets. If this were implemented literally, it would seem that rather than a plan's statement of financial position totalling to zero, the net total would reflect the amount by which the asset in respect of the employer's covenant has been reduced to take account of credit risk. In the usual case where the employer is expected to remain solvent this would seem to add little information: identification of the employer and discussion of the covenant would provide superior information to a somewhat arbitrary deduction from the value of the asset reported in respect of that covenant. However, where the employer's financial position is so precarious, that there is a significant risk that it will be unable to fulfil his obligation, an assessment of the recoverable amount of the asset should be made, and the asset written down to that amount.

7.8 Obviously further disclosures about the employer's covenant are necessary: these are discussed below.

7.9 It is proposed that:

Where an employer undertakes to make payments to a plan to enable it to pay future benefits, then the plan should recognise an asset, reflecting its claim of the employer, based on the difference between its liability in respect of future benefits and the market value of assets available to pay those benefits. The amount reported as an asset should reflect the employer's credit risk.

8 Other matters

8.1 So far we have discussed some of the main items that should be reflected in a pension plan's financial reports—assets to pay benefits (Section 5), liabilities to pay future benefits (Section 6) and the employer's covenant (Section 7). This section looks at some of the other matters that a standard for the financial reports of pension plans would need to address.

A complete set of financial statements

8.2 IAS 1 requires that certain financial statements are presented, and these requirements would seem to be equally applicable to pension plans. These statements include:

- (a) a statement of financial position as at the end of the period;
- (b) a statement of comprehensive income for the period;

- (c) a statement of changes in equity in the period;
- (d) a statement of cash flows for the period; and
- (e) notes, comprising a summary of significant accounting policies and other explanatory information.

These requirements seem equally applicable to pension plans, except that there seems little role for a statement of changes in equity.

8.3 Chapter 9 of this Discussion Paper reviews the disclosure requirements that are desirable for an employer. These would be equally applicable to the pension plan itself, and should be incorporated in the standard for pension plans. Importantly this would include information on alternative measures of the liability, disclosures about risk and details of the composition of board of trustees and their relationship with the employer.

8.4 Obvious additions to these requirements include details of contributions receivable in respect of the period and benefits paid. The financial statements should also record the effect of transfers into and out of membership. Other disclosures are identified in IAS 26 and are uncontroversial.

Investment strategy

8.5 A pension plan's investment strategy and the outcome of that strategy is clearly fundamental to members. Extensions to the requirements proposed in Chapter 9 might be considered appropriate for the financial reports of pension plans.

8.6 The investment strategy should be discussed, describing its objectives and its impact on risk and liquidity. In particular, a breakdown of the strategic asset allocation should be given, with the actual allocation, target allocation and acceptable ranges, making clear both the current and future target allocations with explanations for any notable divergence from the stated policy.

8.7 Where a plan employs investment managers, it would be informative to the member if the financial reports provide a summary of the investment managers used, their investment styles and mandates. This disclosure should include details of the selection and remuneration of managers, including the extent to which remuneration is linked to performance.

8.8 There is also a case for a report on investment performance which would assess the extent to which the investment strategy has been fulfilled, comparing the results to those of previous periods and benchmarks. It would seem appropriate for the trustees themselves to select the benchmarks, rather than for a standard to specify which benchmarks should be used.

Employer's covenant

8.9 In many cases a plan's investment strategy will be influenced by the employer's covenant: all things being equal, the stronger the employer's covenant, the more the trustees may consider a higher risk investment strategy appropriate. Given the importance of the employer's covenant, it would be useful to require a discussion of the strength of the covenant and how the trustees monitor and manage the covenant. This discussion should include information about the possible effect on the plan of major changes to the employer, for example the position in the event that the employer is taken over.

Related party transactions

8.10 The financial report of a pension plan would be incomplete if it failed to disclose all related party transactions and, in particular, transactions with the employer. Although investment in the employer is already commonly given (and is required by IAS 26) other arrangements may also require disclosure (as well as being reflected where appropriate in the financial statements). Such transactions would include, for example, arrangements where assets such as operational properties have been sold to the plan and leased back to the employer.

8.11 The proposals discussed above may be summarised as follows:

The standard for financial reports of pension plans should require a minimum content for the financial statements of plans.

The required disclosures should be built on those identified in Chapter 9 for the employer and those currently required by IAS 26.

Further consideration should be given to disclosures (either in the Management Commentary or in the financial statements) in respect of investment strategy; the employer's covenant; and related party transactions.

9 Summary of proposals

9.1 The proposals made in this Chapter may be summarised as follows:

A standard for pension plans

9.2 IASB should consider withdrawing IAS 26 'Accounting and reporting by retirement benefit plans'. Requirements for the general purpose financial reports of pension plans should be consistent with IFRS. (Section 3)

The objective of financial reports of pension plans

9.3 The objective of the financial reports of a pension plan is to provide information about the financial position, performance and changes in financial position of a pension plan that is useful to members and those who act in their interests, in making economic decisions and assessing the stewardship of the trustees. (Section 4)

Assets available to pay benefits

9.4 Assets available to pay benefits should be stated at current value, which is market value where the asset is traded on a market. (Section 5)

Liabilities to pay benefit

9.5 The standard should require a pension plan's financial statements to include the liability to pay future pensions. (Paragraphs 6.4-6.9)

9.6 The components of a plan's liability should be the same as those identified in Chapter 3 (Paragraphs 6.10-6.13).

9.7 A plan's liability in respect of future pensions should be measured according to the principles identified in Chapter 5. (Paragraphs 6.14-6.19)

The employer's covenant

9.8 Where an employer undertakes to make payments to a plan to enable it to pay future benefits, then the plan should recognise an asset, reflecting its claim on the employer, based on the difference between its liability in respect of future benefits and the current value of assets available to pay those benefits. Where necessary, the amount reported as an asset should be reduced to its recoverable amount. (Section 7)

Other matters

9.9 The standard for financial reports of pension plans should require a minimum content for the financial statements of plans. The required disclosures should be built on those identified in Chapter 9 for the employer and those currently required by IAS 26.

9.10 Further consideration should be given to disclosures (either in the Management Commentary or in the financial statements) in respect of investment strategy; the employer's covenant; and related party transactions. (Section 8)

