

The following summary sets out the main points that are discussed in the PAAinE Discussion Paper: The Financial Reporting of Pensions.

Reporting of Pensions.

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)

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- 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)

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)
- 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*

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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?

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