



**The Financial Reporting  
of Pensions:  
a brief guide**



## **The Financial Reporting of Pensions: a brief guide**

This guide to the new Discussion Paper, The Financial Reporting of Pensions, has been prepared by staff of the Accounting Standards Board (ASB) to explain how it is expected to contribute to the development of international standards, and to summarise what is proposed. The ASB has led work on the Paper, in collaboration with EFRAG and other standard-setters in the PAAinE (Pro-active Accounting Activities in Europe) group.

Fuller details of the proposals, the reasoning underlying them and a discussion of alternative views may be found in the Discussion Paper itself, which may be obtained from the websites of the ASB ([www.frc-asb.org.uk](http://www.frc-asb.org.uk)) and EFRAG ([www.efrag.org](http://www.efrag.org)).

### **Why has the Discussion Paper been produced?**

No-one doubts the significance of pensions to companies, their employees and the economy as a whole. A company's financial statements should provide full and transparent information on the company's exposure to pensions, including any deficit. But existing standards do not always achieve this as well as they might. Some dispute the measurement techniques, and changes in the obligations are not always reported clearly and promptly. Whilst standard-setters are addressing some of the issues, we believe that a fundamental review is needed.

Accounting thinking has moved on since the ASB developed FRS 17, and the then IASC developed IAS 19, in the 1990s. The Paper draws on the latest developments in standard-setting to identify principles for accounting for pensions. These principles may be applied without relying on the distinction between defined contribution (DC) and defined benefit (DB) plans, which is a feature of existing standards, and is troublesome to apply to the hybrid plans that have sprung up in recent years.

## **Proposals for financial reporting by the employer**

### *The pension liability*

A liability for pensions arises in exchange for an employee's services as those services are provided. The liability will be subject to a number of uncertainties—for example the mortality of scheme members—but these affect the amount of the liability rather than its existence. The liability should include all benefits to which there is a present commitment (whether through a legal or a constructive obligation), but should not include benefits that are genuinely discretionary.

### *Future salary increases*

An important issue in applying this principle arises where benefits relate to final salaries. Some (including a majority of ASB members) consider that the present commitment, and hence the liability, relates to current salary levels only, as there is discretion over future salary increases. Others believe that the liability should include the effect of expected increases in salary, as is currently required. Which view is to be taken may depend on whether the liability is viewed as the aggregate of amounts owed to individuals, or as an obligation to the workforce as a whole, since there may be greater discretion over salaries of individuals than over the whole workforce.

### *Whose liability is it?*

The liability may be retained by the employer (as is often the case in Germany, for instance); passed to another party such as an insurance company; or rest with a pension plan sponsored by the employer. In the last instance, which is typical of UK pension schemes, the employer should report a liability only in respect of any guarantee it has given—typically the amount by which the liability to pay benefits exceeds the amount of assets in the plan.

### *Consolidation of pension plans*

However, this assumes that the plan is genuinely independent of the employer, for example where it is governed by trustees that are bound to act in the interests of members rather than in the interest of the employer. If the employer controls the plan, it should be consolidated in the employer's financial statements. This differs from the requirements of current accounting standards which provide an exemption from the usual principles of consolidation for pension plans.

### *Changes in surpluses and deficits*

The amount of pension deficits and surpluses can change markedly in a single accounting period. Current accounting standards, however, permit or require some of these changes not to be reported in the primary financial statements, or to be spread over a number of accounting periods. One example of this is IAS 19, which permits the so-called 'corridor' approach. The Paper notes that these provisions have no principled basis, give rise to considerable complexity and impair transparency. It therefore proposes that all changes in the amounts of pension deficits and surpluses should be reported in the period in which they arise.

### *Measuring the liability—the risk-free rate*

In most countries, there is a regulatory requirement to quantify pension liabilities to enable an assessment of the appropriate level of funding. The techniques used in this process rely on a number of assumptions, including the return that is expected to be made on assets in the time before the benefits will be paid. The Paper notes that these measures do not attempt to assess the present economic burden of the liability and take credit for income that lies in the future: it therefore concludes that they do not provide an appropriate basis for financial reporting.

Instead, the liability should be quantified for financial reporting purposes at an assessment of the cost of settling the benefit, which will typically reflect all future cash flows (including the expenses of administering the liability). Information about the riskiness of the liability is better conveyed by disclosure than by adjustment to the amount of the liability, and so the cash flows should be discounted at a risk-free rate. The rate should not, the Paper proposes, be increased to reflect the credit risk of the liability. This approach differs from current practice, under which cash flows are typically discounted at a high-quality corporate bond rate.

### *Assets and the return on assets*

Consistent with current standards, the Paper proposes that assets held in order to fund pension benefits should be reported at a current value.

Under current accounting standards, financial statements report the expected return on assets, rather than the return actually made in the period. However, the Paper notes that the actual return reflects the economic events of the period, whilst the expected return does not. It therefore proposes that the actual return (including both dividends and changes in the value of the assets held) should be reported in the financial statements, and that information on the expected return should be provided by disclosure only.

### *The income statement*

Part of the change in a pension liability in an accounting period is due to service received and changes made to benefits: this should be reported in the income statement within operating activities. The return on assets and the finance cost relating to the liability (the unwinding of the discount) should be reported in financing, as should the effect of a change in the discount rate. Other changes relate primarily to changes in assumptions and should be reported as income or expenses, but not as part of operating activities or financing.

### *Disclosures*

The Paper sets out proposals for what an employer should disclose in respect of pensions, stemming from the principle that the financial statements should give adequate information on pension costs, risks and rewards, and funding obligations. Details of assumptions and the sensitivity of reported amounts to changes in those assumptions should be disclosed, along the lines of the ASB's Reporting Statement: Retirement Benefits - Disclosures (January 2007).

### *Multi-employer plans*

The principles for reflecting pension benefits are, in concept, equally applicable where an employer is a member of a multi-employer plan, as is common in the Netherlands, for instance. However, there are great difficulties in their application and the Paper discusses ways in which these might be addressed.

## **Financial reporting by pension plans**

Members of pension plans are naturally concerned that their scheme's affairs are properly managed, and financial reporting is one of the means by which their confidence in this can be strengthened. The relevant International Accounting Standard is quite old and contains a number of options. The Paper considers what would be reasonable requirements for pension plan financial reports.

At present, a plan's financial statements may exclude a liability in respect of future benefits. If a liability is included it may be at a regulatory amount that is principally intended to gauge the adequacy of funding rather than to measure the true economic burden. The Paper proposes that a pension plan's financial statements should always include this liability and that it should be stated on similar principles to that which apply to the employer—that is, an estimate of the true economic burden. It also proposes that the effect of an employer's guarantee to the plan should be transparently reported and suggests how this might be achieved.

## What would this mean for financial reporting?

As any future accounting standards on pensions must be developed internationally, the Paper has been framed so as to be capable of general application. The impact of any change will vary, depending on the pension arrangements in existence, but some of the possible effects are:

- If forecasts of future salaries were not reflected in the liability, the reported liability (and hence deficits) would be reduced compared with that reported under many current accounting standards.
- The reported liability would be increased by the use of a risk-free, rather than a corporate bond, discount rate.
- Basing financial reporting on the actual return on assets will tend to result in a more volatile total reported expense for pensions than that which is reported where expected returns are used.
- Whether pension plans will need to be consolidated will depend on the circumstances. For instance, given the independence required of trustees in the UK, it seems unlikely that many UK companies would be required to consolidate their UK pension plans.

## What will happen next?

Comments on the Discussion Paper are requested by 14 July 2008. After consideration of the responses to the proposals, a report setting out final recommendations will be issued for consideration by the IASB and FASB as they move towards a review of international standards.



**Accounting Standards Board**  
5<sup>th</sup> Floor  
Aldwych House  
71-91 Aldwych  
London WC2B 4HN

Tel: +44 (0)20 7492 2300  
[www.frc.org.uk/asb](http://www.frc.org.uk/asb)  
[www.frcpublications.com](http://www.frcpublications.com)