Ask the experts:

Can we improve pension reporting?

IN A SPEECH TO THE ACT ANNUAL PENSIONS CONFERENCE, **PAUL BOYLE** SAID IT WAS TIME TO FOCUS ON CASHFLOWS AND NOT ACCOUNTING STANDARDS IN PENSION ACCOUNTING. **CON KEATING** DISAGREES FUNDAMENTALLY.

Paul Boyle
Chief executive of the Financial Reporting Council

The challenge of giving a true and fair view of a company's financial position and results is extremely demanding and even properly prepared financial statements have considerable limitations. In particular, accounts are backward-looking, although preparing accounts involves judgements about the likely course of future events and this is particularly important in accounting for pensions. And while the operation of pension schemes is a long-term activity, information about short-term performance and current position is also likely to be valuable, which makes the snapshot provided by accounts a strength, not a weakness.

Cashflows for defined benefit pension schemes (where the most challenging accounting issues arise) stretch out for decades. The Accounting Standards Board (ASB, part of the FRC) asked a firm of actuaries to model the cashflow of the benefits paid in a typical (but slightly simplified) scheme. The payments start modestly, reach a peak after 47 years and end after 108 years. The scheme holds the assets that are invested to earn returns and pay the liabilities as they fall due.

The accounting challenge is how best to represent the picture of the inflows and outflows in the financial statements of the sponsoring company and the pension scheme itself: in short, how do we compare a long-term flow of benefits with a current stock of assets?

In the financial statement we could show the value of future liabilities less the future value of present assets. This would mean that the impression given by the financial statements would be consistent with the expectation (or otherwise) that the assets are sufficient to meet the liabilities. The numbers would be forward-looking rather than backward-looking and based on the long term rather than being a snapshot.

The problem is that many treasurers and accountants have a sense of unease about the appropriateness of taking credit in today's financial statements for 100 years' worth of future investment returns. Accounting in this way is likely to be misleading because it does not take account of the risk to those future investment returns.

The alternative to accounting on the basis of future values is present values. It is generally accepted that the best measure of the present value of an asset is what someone will pay for it. Aside from the problem of alternative assets, where a present value is not readily determinable, the present value of assets is relatively straightforward. The question of how to determine the present value of liabilities, particularly long-term liabilities such as pension benefits, is less straightforward to answer.

One measurement basis would be the amount you would pay someone to assume responsibility for the liability; in the case of pension liabilities, the buy-out value.

Another measurement method, much admired by actuaries, is to discount the future liabilities to a present value. An obligation to pay £10,000 in 20 years' time is less onerous than an obligation to pay £10,000 today. The practical question is how much less onerous. We can use discounting, and the further into the future the payment, the greater the effect. A present value of £10,000 in 20 years at 4% is £4,564, in 50 years at 4% it is £1,407. Discounting dramatically shrinks the value of liabilities. And increasing the discount rate makes the liabilities appear even smaller. The present value of £10,000 in 50 years discounted at 7% is £339, a trivial sum, although £10,000 will still have to be found in 2059.

Accounting standard-setters have chosen to represent pension liabilities on a present value basis rather than a future value basis, although the two bases are economically and arithmetically equivalent.

Discounting is a practical technique with a theoretical conceptual underpinning: the time value of money. The theory is only valid in the real world if two critical assumptions hold good: that there is a financial asset that will generate certain returns, and that one has the money today to buy that asset.

There are a wide range of sincerely held views about the merits of different accounting methods and judgments. For example, there is intense debate about discount rates, but the choice of discount rate does not affect the underlying cashflows and it is to them we must look.

My analysis leads me to several conclusions. First, there is a high probability of further shortfalls emerging where there is already a deficit in the pension scheme because the liabilities have been reduced to take credit for the returns on non-existent assets. Second, the higher the rate used to discount pension liabilities, the greater the risk of shortfall emerging. Third, the greater the delay in addressing pension deficits, the greater the amount that will be required to address them. Fourth, companies should consider whether the disclosures they are currently making about the likely future cashflows associated with their pension obligations are adequate to convey a balanced and realistic view of the risk they face.

While existing pension accounting standards perform the very useful function of drawing attention to the importance of pension assets and liabilities, by their very nature they are imperfect and incomplete sources of information. Corporate treasurers, and indeed pension trustees, should focus their attention on developing a better understanding of the cashflows in the pension scheme.

This is an abridged version of Paul Boyle's speech; for the full text, go to www.frc.org.uk/press/pub2003.html
See Profile, p36

Con Keating
Head of research at BrightonRock Group, and chair of the EFFAS (European Federation of Financial Analysts Societies) committee on accounting methods and measures

Paul Boyle notes correctly that the current accounting standards are not based on an assumption of efficient markets, but then offers the bizarre concept that markets are more objective than company management. In fact, the absence of a theory (efficient markets or other) is not a positive and would also render impractical the accounting profession's objective that corporate reports contain information useful for decision-making, since a model or theory is needed to parse data into information and noise.

Objectivity is a strange concept to introduce to financial accounting; it means that we expect values to be discovered rather than created, when we know that financial markets are entirely subjective creations. The fact that a market price for an asset is observable does not mean that this defines the value of that asset: that is a function of the use of the asset. If we are rational, the market price of an asset defines the minimum possible current value to its owners, since they can be expected to sell when the market price exceeds their subjective valuation. Objectivity is immaterial unless those prices are value-relevant, and that is context-dependent.

There are two asset classes of importance in pensions: consumption goods and capital assets. A pension fund invests when it owns capital assets but speculates when it owns commodities. Capital assets draw all their value from this stream of future production.

Paul's concern about the appropriateness of taking credit in today's financial statements for 100 years of future investment returns is contradictory, as this practice is also contained in his preferred choice, a market price, and indeed in many other accounting entries.

The analysis in the ASB's discussion paper on the financial reporting of pensions draws heavily on a set of best-estimate pension scheme liability cashflow projections. Two immediate assumptions are made about this scheme – that it is closed to new entrants and to future accrual – on the grounds that this is progressively the situation for UK pension funds.

The confusion of fund and scheme here is worrying, but much more important is that the analysis is confined to schemes that are entirely legacy situations, with no further new pension provision, no saving and no capital formation. Perhaps the most important question, though, concerns the extent to which the existing accounting standards and rules have themselves brought about a situation where companies no longer wish to provide appropriate pensions for their employees.

By imposing these conditions, the subsequent analysis becomes simply a matter of reinvesting and compounding of investment cashflows in the fund. But the risk-sharing characteristics of a fully open scheme differ dramatically from those of a closed scheme; in effect, there are many more and larger cashflows distributed over time, which bring with them very powerful risk pooling and averaging. Comparative statics can mislead badly with respect to the true dynamics and risk.

It is wrong to say that accounting in this way (using future values) is likely to be misleading because it does not take account of risks to those future investment returns. The 7% rate quoted is a compound multi-year rate; it is a certainty-equivalent rate, a post-risk rate. This is equivalent to a flat zero coupon yield curve which is everywhere 7%. It might be achieved by buying an asset with an arithmetic yield or return of 7.5% and volatility of 10%, or by a myriad of other equivalent asset couplings today.

Paul says that the best measure of the present value of an asset is what someone would pay for it. Here again, terms are confused. Perhaps, this was intended to read as the best measure of the current value, in which case it would be merely contentious. However, the subsequent suggestion that "buy-out" quotations be used to value liabilities confirms a worrying lack of comprehension of this market.

A buy-out quotation is the price an insurance company demands to buy the liabilities of the pension scheme. This price results from much regulation and as such is an artificially high cost to the scheme. If any company were allowed to acquire the liabilities of the pension scheme, the buy-out price would be closer to 70% of the actuarial best estimate rather than the 130% evident for typical insurance buy-out quotations.

In his comments on the theory and practice of discounting, Paul invents two critical conditions for validity of the discounting technique. In truth, neither a highly specific security nor the possession of cash is necessary for discounting to apply.

I also take issue with Paul's conclusions. The first is simply incorrect: liabilities are at no time reduced. The second is equally wrong: a miscomprehension of probability theory. If it were true that the higher the discount rate used, the greater the risk of shortfalls emerging, then we would have to consider explicitly the meaning of a shortfall of a pension fund. What is true is that, other things being equal, the lower interest rates are, the more time there is to repair pension deficits or shortfalls.

And that leads into Paul's third conclusion, which may prove true, but only in very limited circumstances. The final conclusion is one we can all agree with. After all, the current mixed attribute standard of market prices for assets and discounted present values for liabilities results in a biased mis-statement of the true and fair position. Under the current standard, deficits are mis-stated – exaggerated by something of the order of 25% of best estimate liabilities for most schemes. Let's augment disclosures with those values.

The criticism I would level at accounting is not that it is influencing decisions but that its influence in its current form results in incorrect, distorted and inefficient decisions. There appears to be a belief held by accounting standards-setters that there is a unique and "true" price for an asset or liability, when the reality is that, in the presence of uncertainty, many prices may co-exist and judgement is needed to determine value.

For Brighton Rock's full response to the consultation, go to www.brightonrockgroup.co.uk/PressArticles.html and choose the Response to ASB PAAinE Consultation option

THE CRITICISM I WOULD LEVEL AT ACCOUNTING IS NOT THAT IT IS INFLUENCING DECISIONS BUT THAT ITS INFLUENCE IN ITS CURRENT FORM RESULTS IN INCORRECT, DISTORTED AND INEFFICIENT DECISIONS.

Readers interested in contributing to the debate should email their comments to modonovan@treasurers.org