INCLUSION OF ACTUARIAL LIABILITIES IN THE FINANCIAL STATEMENTS OF PENSION SCHEMES

A CONSULTATION PAPER

Purpose of this consultation paper

This consultation paper sets out to examine the question of whether pension scheme financial statements should be expanded to include disclosure of the scheme's actuarial liabilities. It looks at the question from a number of different points of view – that of the actuary, the auditor and above all the users of the financial statements, including scheme members. It tries to examine the question in terms of the fundamental application of accounting standards as well as in terms of the practical issues that may arise if these liabilities were to be included.

The inclusion of actuarial liabilities is a very significant issue that would have a major impact on everyone involved in the preparation and audit of pension scheme financial statements. PRAG has accepted the challenge of leading a debate within the pensions industry on this question, and hopes that this paper will help structure the debate and the responses to it. Questions are highlighted at the end of each section of the paper, but general comments will also be welcome. Readers can respond via the PRAG website (www.prag.org.uk), or in writing to:

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The consultation period will close on 28 February 2003, and PRAG plans to publish the results of the consultation exercise on its website during the second quarter of 2003.

Background

The financial reports of pension schemes have until now consistently been viewed as an account of the stewardship by the trustees of the assets under their control – the investment assets, cash resources and so on. They have been used by trustees to demonstrate to scheme members and other interested parties how they have managed these assets, collected contributions and other income due to the scheme and settled benefits and other expenditure that fell due for payment during the accounting period.

Current pension scheme regulations confirm that this is all that is required for pension scheme financial statements. The Occupational Pension Schemes (Requirement to obtain Audited Accounts and a Statement from the Auditor) Regulations 1996 require audited accounts to show a true and fair view of "the amount and disposition of the assets … and the liabilities of the scheme, other than the liabilities to pay pensions and benefits after the end of the scheme year". These liabilities to pay pensions and benefits after the end of the accounting period are the long-term liabilities of the scheme and are generally referred to as the 'actuarial liabilities'. It should be noted that while the Regulations quoted do not *require* the inclusion of the actuarial liabilities in the scheme's accounts, they do not preclude their inclusion should the trustees choose to do so. There are however no known examples of trustees choosing to disclose the actuarial liabilities directly in the scheme's financial statements.

Trustees are required to make readers of their accounts aware that the accounts do not include the actuarial liabilities. The accounting policies disclosure should make it clear they are excluded, and the annual report (of which the accounts form a part) must describe the actuarial status of the scheme and advise members where further information (such as a copy of the actuarial valuation report) can be obtained. However, nowhere in the accounts or annual report is there a direct quotation of the actual value of the actuarial liabilities. This means that it is very difficult for, say, a prospective member to use the scheme's accounts in deciding whether to join the scheme on the basis of its funding position. The conclusion could therefore be drawn that pension scheme accounts fail to meet the fundamental purpose of accounts, which is the use by readers of accounts in economic decision making. The demonstration of stewardship is increasingly viewed as a secondary purpose by accounting standard setting bodies, which is in conflict with the traditional primary purpose of pension scheme accounts.

Many employers who sponsor defined benefit pension schemes have recently experienced changes to the requirements for accounting for the costs of their schemes in their own accounts. Under FRS 17 *Retirement Benefits*, employers now have to disclose on their balance sheets the deficit or recoverable surplus in the pension scheme. This surplus or deficit is derived from the difference between the value of the assets of the pension scheme and the value of its liabilities, calculated using prescribed actuarial assumptions. It has been pointed out that it seems counter-intuitive that a pension scheme member is able to find out more about the funding position of the scheme from reading the accounts of the employer than from reading the accounts of the scheme itself. And of course, there is not necessarily a one-to-one relationship between schemes and employers, so some members will

not be able to use employers' accounts directly to investigate their scheme's funding status.

Other accounting standards have an impact on this debate. FRS 5 *Reporting the substance of transactions* addresses the problem of what is commonly referred to as off-balance sheet financing and there is no dispute that a pension scheme's actuarial liabilities are not recognised on the scheme's net asset statement. It has been strongly argued that pension scheme liabilities fall within the definition, contained in FRS 12 *Provisions, contingent assets and contingent liabilities*, of "provisions" as "liabilities of uncertain timing and amount" and so need to be accounted for in the scheme's accounts. The recent revision of PRAG's Statement of Recommended Practice *Financial Reports of Pension Schemes (Revised November 2002)* only received qualified approval from the Accounting Standards Board on the grounds of non-compliance with FRS 12. However, it is also true that none of the examples or illustrations given in these accounting standards indicate that pension schemes were primary targets for the standard setters when the standards were drawn up.

There is also an international aspect to the debate given the drive towards common international accounting standards. The relevant international standard for pension scheme accounts, IAS26 *Accounting and Reporting by Retirement Benefit Plans*, does require the inclusion of the value of actuarial liabilities in the scheme's financial statements, unlike the UK SORP. IAS26 gives a number of options for the presentation of this value; it can be disclosed on the face of the primary statements, or within the notes thereto, or within a separate document (e.g. an actuarial valuation report) appended to the accounts.

In summary, pension schemes and in particular their funding position are increasingly in the spotlight, from scheme members and prospective members, from employers and trustees, and from regulators and accounting standard setters. Pension scheme accounts play a crucial role in presenting financial information to all these parties. The challenge presented by this consultation paper is to see if there are ways of giving the readers of pension scheme financial statements better information on the liabilities of the scheme, without sacrificing the clarity and simplicity of the current format of pension scheme financial statements.

Actuarial aspects of relevant accounting standards

Should any or all elements of the actuarial liabilities be recognised?

The main accounting standard driving recognition of actuarial liabilities in pension scheme accounts is FRS12. But a detailed examination of the standard raises the question as to whether any or all elements of the liabilities should be recognised. For example, FRS 12 states that contingent liabilities should not be recognised in an entity's financial statements, defining a contingent liability as:

> *A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the entity's control;*

'Entity' means the entity whose financial statements are under consideration, which for pension schemes is of course the trust under the control of the trustees. It can be argued that salary increases by the employer are not under their control and therefore the pension liability in respect of future salary increases falls within the definition of contingent liability under (a) above, and hence should not be recognised. On similar arguments, any contingent provision for discretionary pension increases should be excluded.

The argument can be taken even further – are actuarial liabilities in their totality real or contingent? It can be argued that their nature and value is only confirmed by events outside the trustees' control, for example, the death, retirement or early leaving of the employees. The purpose of an actuarial valuation is to a large extent to bring some statistical or mathematical rigour to the mass of uncertain future events that impact the liabilities – but is the same as saying that they are real liabilities that qualify for recognition under FRS12? This standard requires recognition of liabilities where (and only where):

a. *an entity has a present obligation (legal or constructive) as a result of a past event;*
b. *it is probable that a transfer of economic benefits will be required to settle the obligation; and*
c. *a reliable estimate can be made of the amount of the obligation.*

What is the relevant definition of 'actuarial liabilities'?

The primary user of the pension scheme's accounts is the member, who is interested in three questions. What will happen to my pension if my employer

- remains in existence and continues to support the scheme?
- continues in existence but ceases to support the scheme?
- becomes insolvent?

In considering the alternative actuarial liabilities that might be disclosed in the accounts, it is important to consider whether any of them gives the member a meaningful answer to these questions, and at a cost that is reasonable.

MFR liability

In the majority of cases, this is the only liability that the Trustees of an Occupational Pension Scheme can legally enforce against an ongoing

employer in the event that he ceases to support the scheme (although there may be cases where the trustees have greater powers). It is also the minimum level of funding that the trustees must seek to achieve in an ongoing situation. The members would have some interest in seeing the extent to which the trustees have been able to maintain this minimum level of funding.

Beyond this, the MFR would not deliver meaningful information to current deferred pensioners and active members. The adjusted MFR, which requires pensioner liabilities to be assessed at a buy out cost would then only give a measure of the extent to which members could take transfer values rather than guarantee a level of cover for their accrued benefits.

In terms of calculation, many actuarial firms will have developed software that will enable them to estimate on a roll forward basis the level of MFR solvency. Provided the auditor is willing to accept an approximation this number could be made available relatively easily.

The liabilities taken into account in an MFR calculation – i.e. deferred pensions for existing active members and excluding discretionary pension increases – would be consistent with the interpretation of the requirements of FRS12 set out above.

Discontinuance liability – buy out basis

This approach would at least seek to answer the third question, and probably also the second question, set out above. As the results are only likely to be made public some 7 or 8 months after the effective date, their usefulness is somewhat diminished.

For smaller funds, it would be possible to place a meaningful value on the discontinuance liabilities as they would be assessed by an Insurance Company. If, however, a disclosure of this level of funding is to be made for all schemes, the only practical approach would be for insurers to release details of their costing bases, which would be commercially sensitive, and for auditors to ask Scheme Actuaries to complete the calculations.

For larger schemes, any buy out process would be completed over an extended period of time. Therefore, a disclosure of the discontinuance position at a particular date would not give a reliable estimate of what could actually be achieved in practice.

The Faculty and Institute of Actuaries are currently considering the question of how to estimate the value of discontinuance liabilities in conjunction with a triennial valuation. Once again, this is likely to be a theoretical exercise. In addition the calculations may be quite complex; whilst these can reasonably be undertaken as part of the triennial valuation process, the requirements might be costly to implement if they were to be repeated in non valuation years.

FRS17

If the accounting years for the employer and the pension scheme coincide, a calculation of the FRS17 liabilities at the accounting date will be made. However, the point is made above that the appropriate liabilities under FRS12 – as far as the trustees are concerned – exclude future salary increases and discretionary pension increases. In that sense, a calculation would be

required on a different basis from the one already being carried out for the employer.

Even if the calculations were to be carried out in accordance with FRS17, a further issue arises. In the event of there being, say, a deficit on FRS17, this is required to be shown in the employer's balance sheet. If such a reserve is to be shown, should it not be treated as an asset of the pension scheme? If so, the calculation is a meaningless exercise as, in the pensions scheme's accounts, the assets and liabilities would always be precisely equal, with any deficit (or surplus) being balanced by an entry in the employer's balance sheet.

Ongoing funding basis

For the majority of occupational pension schemes (at least by size of fund and number of members) the process of establishing an ongoing valuation basis is a lengthy exercise undertaken at successive triennial investigations. In the past, these bases may have demonstrated a degree of stability over time. However, with market value bases becoming increasingly predominant, the appropriate valuation basis to adopt at successive accounting dates is unlikely to be a minor adjustment to the previous one.

Some employers currently undertake annual reassessments of the funding position of their schemes; this will be particularly true for the larger entities. However, others regard the triennial valuation as an appropriate means of assessing the solvency of the pension arrangements on an ongoing basis, which will also address questions of discontinuance solvency and MFR solvency at the same time. On the basis that the employer ultimately meets the cost of the pension scheme, they may be prepared to sanction an approximate roll forward of the position from year to year. However, this places the auditor in a more difficult position in that the calculations will not have been based on accurate data. The scheme actuary is likely to wish to caveat the results, particularly if they are to be made more publicly available – the purpose of many interim reassessments is more to determine whether the existing contribution rates established at the last triennial valuation remain reasonable rather than as a precise calculation of the funding position at a specific date.

Can one figure ever give a complete answer?

A scheme's liability will depend on whether the scheme continues or winds up and the degree of risk assumed for the pension promise. It is common for actuaries to report the scheme's liabilities to the Trustees on several bases. These include scheme continuing with future accrual, the accrued liability position allowing for future salary increases, accrual ceasing (e.g. accrued liability position allowing for revaluation increases) and the scheme winding up with possible purchase of accrued benefits from an insurance company.

If the position on several of these bases were included with explanation in a full funding disclosure note in the Scheme's annual report to members (or elsewhere), this might promote greater member understanding of the true funding position rather than relying on one bald figure in the scheme balance sheet.

Questions:

In your opinion, are actuarial liabilities present obligations that should be recognised in pension scheme accounts under FRS12, or are they contingent liabilities that should not be recognised?

If actuarial liabilities are to be recognised in pension scheme financial statements, what actuarial basis or bases would be most appropriate?

For your scheme, or a scheme with which you are familiar, what is the likely impact on actuarial fees of the inclusion of actuarial liabilities in pension scheme financial statements?

Disclosure issues

Needs of Users

The needs of users, other than members, for information about funding can normally be met from other sources:

- Trustees and Employers have full access to actuarial valuations and will be involved in the process for setting the contribution rates.
- Regulators have alternative means of obtaining information. They do not require the filing of Trustees' Report and Accounts, so will not be relying on Accounts for information about funding.
- Shareholders of Employer(s) will rely on the employer's accounts and FRS17 information contained therein.

It can be argued, therefore, that the primary focus should be on the needs of members. It should, however, be recognised that:

- most members rely on popular reports rather than the Report and Accounts for information, and that
- all members are entitled to see a copy of the full actuarial valuation, so the Accounts are not the only means by which members can obtain information about the funding of the Scheme.

The questions that are of the greatest interest to members are typically:

"Is my pension safe?" or "Will I receive my pension in full?"

These are questions to which there is normally no simple direct answer. In most schemes the answer is "It depends" –

- Principally on the willingness and ability of the employers to continue to fund the scheme, but also
- on future investment returns
- on the economic environment and future inflation rates, and
- on the longevity of pensioners.

The challenge for trustees is how best to communicate to members information on funding to enable them to formulate their own response to the questions above. In his recent report Alan Pickering concludes that: "too much emphasis has been placed on the disclosure of information to members. Provision of information is important but not a panacea. We recommend a much more targeted approach to communicating with scheme members that focuses more on key pieces of information and does not overload them with information that only causes confusion."

The government is developing proposals for new disclosure on funding as part of the replacement of the MFR and it may be that those disclosures satisfy members' needs more effectively than changes to the content of scheme accounts. The actuarial profession is also considering changes to GN9 under which actuarial reports would include a statement of the "discontinuance position and how different priority classes

are affected". This statement, if made more widely available to members, would also be an important source of information.

Existing Disclosure Requirements

It can be argued that the existing requirements do not in themselves produce satisfactory disclosure. The formal actuarial reports required may be difficult to understand because of the format and presentation, especially where there is a sharp reduction in the level of funding between a full valuation and a recertification of a schedule of contributions.

Existing disclosure may work best where the formal actuarial statements are accompanied by a more informal statement from the actuary about funding.

Proposed Disclosure – where an actuarial liability is included in the Scheme Balance Sheet

Whilst disclosure may need to be improved, the inclusion of an actuarial balance sheet may give a false sense of certainty about the funding level and encourage short term thinking. It would not be appropriate to show liabilities alongside assets as though they were valued on entirely consistent bases when that was not the case. It may therefore be preferable that the additional disclosure is included in a separate statement that would replace the existing actuarial certificates.

If an actuarial balance sheet is prepared the accompanying disclosure needs to explain:

- the long term nature of the assumptions used to value the liabilities,
- that the assets are valued at market value which, (to the extent of any mismatch), will not move in line with the liabilities,
- the sensitivity (in general terms) of the result to the precise level of the assumptions, and
- the reliance on the employers' ability to continue to fund the Scheme.

If an actuarial liability is to be included there are a number of bases on which the liability could be calculated:

- "Ongoing" funding - the funding basis used by the actuary for the scheme.
- MFR – consistent across schemes, but question as to what form new MFR basis will take and as to usefulness to members.
- FRS 17 – also consistent across schemes – but not the basis used for funding the scheme – and therefore not of any direct relevance from the trustees' perspective.
- Discontinuance – is this relevant as the primary basis of measurement for an ongoing scheme.

It can be argued that for an ongoing fund an ongoing basis should be used to calculate the liability to be included in the balance sheet. The trustees would therefore need to reach a judgement as to whether the fund was ongoing. This may require the trustees to obtain an (annual) confirmation from the

Principal Employer that it has no present intention of discontinuing the Scheme.

For an ongoing scheme should then discontinuance information also be disclosed? If so, discontinuance data that values active/deferred liabilities on a cash equivalent basis is not helpful and either a buyout or a closed scheme basis should be used (see below). The main argument in favour of providing discontinuance data is that it will always be difficult for trustees to assess for how long a fund will be ongoing – hence the possible reliance on a confirmation from the employer. It is therefore reasonable to give members data on both bases and leave it to them to decide which is appropriate. The counter argument is that it is inappropriate to provide discontinuance data when the trustees have no reason to suppose that the fund is not ongoing and when the provision of such data could be seen as being unnecessarily "alarmist" and the preparation of the data on an annual basis would add substantially to costs.

Where the principal employer has decided not to continue the Scheme actuarial data should be prepared on either a buyout basis or a closed scheme basis. (The actuary would decide which was appropriate – for small schemes buyout would be the only practical alternative, whereas for large schemes, where there was insufficient market capacity for a buyout, running on as a closed scheme would be necessary.)

Disclosure might include the following:

- Explanation as to whether actuarial data is based on a full valuation or an annual review.
- Description of overall basis used (ongoing – discontinuance) (projected unit, attained age etc).
- Explanation of assumptions – this should be more than a list of four of five financial assumptions in that it should include a short explanation of the derivation of the investment return assumption including the extent of any excess that has been assumed over gilt yields (equity risk premium, credit spread on corporate bonds etc). This explanation will need to refer to the investment strategy being followed. [Specific reference should also be made to mortality.]
- Where there is a deficit, the levels of funding applicable to the various classes of beneficiary, having regard to their priority on a winding-up, should be disclosed.
- The contributions being paid under the Schedule of Contributions then in force, with certification from the Scheme Actuary as to their adequacy. [The certificate might be in the same form as that currently required under the Disclosure Regulations.] Where the contributions include funding in respect of a deficit, the period over which the deficit is being funded should be disclosed.

Proposed Disclosure – where an actuarial liability is not included in the Scheme Balance Sheet

Disclosure would be the same as that where an actuarial liability is included in the balance sheet, but with the addition of disclosure of the amount of the liability to provide pensions in the future and the % level of funding.

Questions

Do you agree that the primary focus should be on the needs of members? If so, to what questions do members wish to receive answers?

Are the existing disclosures about funding and the actuarial position in pension schemes' annual reports adequate?

Can additional disclosure best be made by the preparation of an actuarial balance sheet or by the provision of separate information about funding?

When principal disclosure is on an ongoing basis should discontinuance information also be provided?

If separate information is produced about funding how should it be communicated to members? Should it be required to be appended to the annual report (as allowed for by IAS26 currently) or be made available only on request?

Audit considerations

Under the Audited Accounts Regulations, the trustees of most UK occupational pension schemes are required to appoint an auditor and to obtain audited accounts of the scheme within seven months of each scheme year end. Failure to comply with these requirements leaves trustees open to fines and, potentially, disqualification orders from Opra.

The inclusion of actuarial liabilities within the accounts poses some significant practical issues for trustees in fulfilling these requirements, which centre on the ability of the auditor to carry out the necessary audit work, within the required timescale, on the actuarially derived numbers. For example

- The actuarial information necessary for the trustees to be able to prepare the accounts and for the auditor to be able to carry out the necessary audit work must be available on a timely basis.
- Auditors will need to gain sufficient understanding of the methods, assumptions and other significant inputs that have been used in the calculation of the actuarial liabilities. In many cases, this is likely to involve having access to advice from an independent pensions actuary. There is a cost implication with having to seek such advice in addition to a resourcing issue, in particular for smaller audit firms which do not have in house actuarial teams.

Without the timely availability of information and sufficient expert input, auditors might be forced to conclude that they are unable to carry out all the audit procedures necessary and would be forced to qualify their opinion on the grounds of a limitation of audit scope.

There is some guidance in relation to auditor and actuary liaison – see the FRS 17 Practice Note and the ICAEW technical release (1/02). Similar guidance to this would have to be issued.

Alternatives to full recognition

There are potentially some alternatives to the auditor signing a conventional audit report on pension scheme accounts which contain actuarial liabilities. These might include:

- A joint statement by the auditor and the actuary, in which the actuary takes responsibility for the figures that he has calculated; or
- A special audit report in which the auditor states that he has relied on the scheme actuary.

However, such reports are unprecedented among other industry sectors.

Questions:

What do you see as the implications for auditors of the inclusion of actuarial liabilities in pension scheme financial statements?

For your scheme, or a scheme with which you are familiar, what is the likely impact on audit costs of the inclusion of actuarial liabilities?