

SOME THOUGHTS ON THE UK FINANCIAL REPORTING STANDARD No. 17

1. The Standard is about the accounts of the sponsoring *corporation* [company] (the employer). It is not about the accounts of the pension fund. The Standard appears to apply to the situation where the fund is *autonomous* [independently controlled and with segregated assets]. Administrative costs of the fund and actual pension payments do not appear in the Standard. The actual *property income* of the fund [its investment income excluding net capital gains] and its actual *net holding gains* [net accrued capital gains, realised and unrealised] appear in the employer's accounts, in total, only as part of a reconciliation item.
2. A deficit of a defined benefit fund under the standard is attributed to the employer and appears as an actual liability, rather than as a contingent liability, in his balance sheet. Conversely, with limitations, a surplus can be treated as an asset of the employer¹. Deficits and surpluses are measured, as in System of National Accounts 1993 (SNA), as the difference between the market value of assets and the actuarial value of liabilities.
3. It seems to me that the reason for the emergence of large deficits in the UK under the standard is not just the collapse of the stock market. The substitution of a discount rate for liabilities, based on the yield of high quality corporate bonds, in place of the (usually higher) assumption about the long-term growth rate of assets is also, it seems, a major factor².
4. The most important feature of the Standard, in our context, is that it provides an itemised annual link between the opening and closing deficits/surpluses of a defined benefits fund, as measured using the market values of assets. In SNA, this link is rather vague. Since at present the "*net worth*" [deficit or surplus] of the fund is not attributed to the sponsoring employer, the movement appears, if at all, in the accounts of the fund. The fund receives contributions as they fall due (employers' plus employees'), receives property income as due, has expenses of administration, probably does not have an *operating surplus* [broadly speaking, trading profit before interest], and receives net holding gains. But the actuarial value of the employer's/fund's outstanding liabilities to current and retired employees changes for other reasons. It is not entirely clear in SNA where this is recorded – could it be as the single item "insurance technical reserves" (AF6) on

¹ In some countries, a surplus is treated as an asset of the members, at least in a wind-up situation. I believe this is so by law in New Zealand.

² When actuarial valuations for assets (that is, valuations based on projections of property income) are used, it is evidently necessary to have the same discount rates (whether nominal or real) for both assets and liabilities. If, as in the case of a young fund, pension payments are further in the future than receipts of property income, the higher the discount rate, the lower a deficit or the higher a surplus. A lower discount rate increases a deficit and reduces a surplus, in these circumstances. When market values of assets are used and actuarial valuations are used only for liabilities, this effect is exacerbated, because the parallelism between discount rates on both sides is lost. The effect of a change in assumption about the discount rate is therefore increased; and in addition volatility is introduced through fluctuations in the market values of assets.

the changes in liabilities side of the “*other changes in volume of assets [/liabilities] account*”?

5. In the Standard, the “Movement in surplus [/deficit] during the year”, as attributed to the employer, is analysed in the following way (see its Appendix 1):-

- 1a. Current service cost
- 1b. Past service cost
- 1c. *less* Contributions (total, less employees’ contributions)
- 2. Other finance income
- 3. Actuarial gain [/loss]

6. “Current service cost” is net of employee contributions. It is to be included within operating profit within the profit and loss account. It will differ from employer contributions in a number of circumstances. The two are not the same in the illustration in the FRS, even allowing for “past service cost”⁴. If there is a deficit on the valuation basis used for funding decisions, the actuary will recommend increasing total contributions, including a new element designed to pay off the deficit over a number of years. In the case of a “young” fund, this period might well be 10 or more years. This is the effect on cash flow – a total of contributions which relates to both current service and to eliminating a deficit. The treatment of a deficit or a surplus in the FRS appears to be different. First, the deficit or surplus may be estimated differently. Secondly, a deficit appears to be scored immediately in the balance sheet, though at what point and in what years it appears in the rest of the accounts is not clear to me. But it appears that “current service cost” relates to current service only, not to the elimination of a deficit.

7. Two different figures make up the heading “Other finance income”. They are the “Expected return on assets” (long-term assumed rate of return x opening assets at market values) and “Interest on pension scheme liabilities” (long-term discount rate x opening present value of liabilities). The net amount, expected return less interest on liabilities, is called the “Net return” and is credited to the heading “Other finance income”. These figures are of expectations and include expected holding gains. They bear no relation to actual flows of property income and actual holding gains. At first sight this seems to cause obvious difficulties for the articulation between institutional sectors of the national accounts. However, it may be that, in a revised SNA, the item could be left in the “Other changes in the volume of assets account”.

⁴ This is also charged to operating profit. It has to do with enhancing benefits which apply to all employees, not just to new joiners. If benefits are enhanced, current service cost will increase in the current and later years; and the cost of enhancing benefits not covered by past service contributions can either be dealt with by attributing a surplus in the fund (the usual situation when benefits are enhanced) or by a decision to enhance them anyway, and so to increase current and future contributions. In the first case, the past service cost is probably scored in single year, but in the second the impact on cash flow will be spread (but perhaps not spread in the accounting standard).

8. The difference between the actual and the expected return on assets appears as part of the “Actuarial gain [or loss]”. It is analysed in another Table called “Analysis of the amount recognised in the statement of total recognised gains and losses” (STRGL), which is derived from another Standard but appears to have similarities with the complex of ‘financial’ accounts in SNA. (Presumably the actual return on assets includes holding gains and losses.) Similarly for “Experience gains and losses on liabilities” and “Changes in assumptions underlying the present value of the scheme liabilities”. The total of these three elements is entitled “Actuarial gain (or loss) recognised in the STRGL”. Paragraph 37 of Appendix IV says

“ The Board regard actuarial gains and losses as similar in nature to revaluation gains and losses on fixed assets. . . . Market fluctuations [of the assets in the pension scheme] are incidental to the main purpose of the pension scheme just as the revaluation gains and losses on a fixed asset are incidental to its main operating role. They are therefore best reported within the statement of total recognised gains and losses.”

9. Thus actual employer contributions appear in the employer’s accounts only in the table called “Movement of surplus during the year”, where contributions are positive and the cost figures are negative. Actual property income of the fund affects the employer’s accounts only as part of the analysis of “actuarial gain [/or loss]”.
10. Care may be needed over the treatment in employer accounts of the administrative costs of an autonomous pension scheme. (Broadly speaking, they equal *Output* in SNA, in the case of a non-profit making body). It appears that the FRS, like SNA in the case of an autonomous fund, registers these as costs of the fund (in SNA, they are charged to the employees as a service) which are financed by the total income (contributions and property income) of the fund. However, this is not quite explicit – I only note that there is no mention of administrative costs in the definition of “current service cost”. In my experience, however, admittedly in the case of a small fund, I believe that the company paid the administrative costs directly (mainly actuarial fees, in this case); if so, they were not scored as costs of the fund, when settling the employer’s contribution rate.

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