

Key Pensions Accounting

In his speech at this year's ACT Pension Conference on the topic of key pension accounting and reporting, Paul Boyle quoted a Sunday Times journalist of sixty years ago who observed: "...some unpleasant facts can emerge when proper accounts are kept." Some things are timeless and indisputable.

Newspaper headlines do though seem to hold some considerable importance for the ASB, as elsewhere in the speech, it credits a Times headline, "*Companies hide truth about pension deficits*", as having been instrumental in the issuance of the 2007 Reporting Statement: Pension Benefits. Interestingly, I don't recall this fact being broadly disseminated at the time, when I did debate these issues with Ian Mackintosh at an NAPF conference.

Having produced a submission for last year's Discussion Paper on "The Financial Reporting of Pensions, I studied the speech keenly for indications of new thinking by the ASB arising from that "from first principles" debate. Beyond the news that we can expect a further paper later this year, the speech was entirely disappointing.

It appears that Sir Francis Bacon is yet again to be proved correct: "*The human understanding when it has once adopted an opinion draws all things else to support and agree with it. And though there be a greater number and weight of instances to be found on the other side, yet these it either neglects and despises, or else by some distinction sets aside and rejects, in order that by this great and pernicious predetermination the authority of its former conclusion may remain inviolate.*"

In this article I shall correct a number of factual errors and also examine critically many of the arguments put forward in the speech; I regret to say that I find it sadly wanting.

Paul notes correctly that the current accounting standards are not based upon 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; this failing has been a recurrent theme in econometric thought, first widely evidenced by Koopman's 1947 "*Measurement without Theory*" critique of Burns and Mitchell's magnum opus "*Measuring Business Cycles*". Interestingly, the absence of any theory 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 an owner can be expected to sell when the market price exceeds their subjective values of the asset. Objectivity is entirely immaterial unless those prices are value relevant, and that clearly is context dependent.

It is worth drawing attention to an important distinction in the classification of assets. There are two forms which are relevant in the case of pensions: consumption goods such as commodities and capital assets. These latter assets are productive goods; for example, the farm that produces the commodity we consume. In a pension fund, we are investing by owning capital assets but speculating when owning commodities. Capital assets draw all of their value from this stream of future production – whether traded in markets or privately negotiated.

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

The analysis, such as it is, in the paper draws heavily upon a set of best estimate pension scheme liability cash-flow projections supplied by a leading firm of pensions actuaries. Two immediate assumptions, that it is closed to new entrants and to future accrual, are made about this scheme - these assumptions are justified with the observation that this is "*progressively becoming the situation for UK pension funds.*" The confusion of fund and scheme here is worrying, but much more important is that the analysis is then confined to schemes which are entirely legacy situations – no further new pension provision, no saving, no capital formation. Perhaps the most important question though concerns the extent to which the existing accounting standards and rules themselves brought about the 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 the reinvestment and compounding of investment cash-flows occurring within the fund. The analysis following in the speech is then only one of elementary comparative statics rather than dynamics. The risk sharing characteristics of a fully open scheme differ dramatically from those of a closed scheme - in effect there are many more, larger cash-flows distributed over time which bring with them very powerful risk pooling and averaging. The comparative statics can mislead badly with respect to the true dynamics and risk.

Paul asserts incorrectly 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*" – this is a gross error. The seven per cent 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%. The confusion surrounding risk is further demonstrated by the assertion "*I have scoured the market place for an asset which offers 7% compound, risk-free over 50 years. Perhaps anyone here today who knows where I could buy such an asset could (sic) let me know in the tea interval.*" In fact all that is needed is a certainty equivalent yield of 7% and that 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 later asserts that *“It is generally accepted 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 confirms a near total lack of comprehension.

A “buy-out” quotation is the price that an insurance company demands in order to acquire 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. The simple fact is that long-term liabilities of the form and nature of pension liabilities are the stuff of dreams as financing for most corporate treasurers and finance directors. Given the earlier challenge to a 7% rate, readers may wish to consider how attractive such financing would currently be to them.

In a section entitled *“Discounting: theory and practice”*, two critical conditions for validity of the discounting technique are invented. Contrary to the assertion there, neither a highly specific security nor the possession of cash is necessary for discounting to apply.

I could criticise many other aspects of the quixotic discussion of discounted present values that follows, or the speech more generally, but in the interests of brevity I shall confine myself to comments on Paul Boyle’s personal conclusions.

“First there is a high probability of further shortfalls emerging in cases 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.”

Liabilities are at no time reduced. The sentence as written is nonsensical, and even under reasonable interpretation simply incorrect.

“Second, the higher the rate used to discount pension liabilities the greater the risk of shortfalls emerging at a later date.”

This again is simply incorrect, a miscomprehension of probability theory. If it were true, it would require us to consider explicitly the meaning of a shortfall of a pension fund. What is true is that, *ceteris paribus*, the lower interest rates are, the longer we have to repair pension deficits or shortfalls, and that leads into Paul Boyle’s third conclusion, which may prove true, but only in very limited circumstances.

“Third, the greater the delay in addressing pensions deficits the greater the amount which will ultimately be required to address.”

The final conclusion:

“Fourthly, (sic) companies should consider whether the disclosures which they are currently making about the likely future cash-flows associated with their pension obligations, even if those disclosures fully comply with existing accounting standards, are adequate to convey a balanced and realistic view of the risks which they face.”

Finally, we have a conclusion with which we can agree. 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, that is to say exaggerated by something of the order of 25% of best estimate liabilities for most schemes; let’s augment disclosures with those values.

The assertion: *“But what better reporting of pensions cannot fairly be accused of is increasing the risks: the risks are already there.”* is of course only true if the reporting is now accurate – but currently it is the accounting standards which exaggerate risks rather badly.

The criticism that I would level at accounting is not that it is influencing decisions but rather that its influence in current form is malign and 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 judgment is needed to determine value.

In light of the Financial Reporting Council’s responsibility for the promotion of confidence in corporate reporting and governance, this speech was profoundly disconcerting.

Copies of the speech and related slides are available at:
<http://www.frc.org.uk/about/pub2004.html>