Statement of Recommended Practice: Financial Reports of Pension Schemes Exposure Draft

RESPONSE FROM ICAS TO THE PENSIONS RESEARCH ACCOUNTANTS GROUP

16 July 2014
Introduction

The ICAS Pensions Committee welcomes the opportunity to comment on PRAG’s proposed Statement of Recommended Practice (SORP) for the financial reports of pensions schemes.

Our CA qualification is internationally recognised and respected. We are a professional body for over 20,000 members who work in the UK and in more than 100 countries around the world. Our members represent different sizes of accountancy practice, financial services, industry, the investment community and the public and charity sectors.

Our Charter requires ICAS committees to act primarily in the public interest and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members’ views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount. For example, the ICAS Pensions Committee has published two high profile reports on pensions in an independent Scotland in the context of the Referendum debate. Our reports which have been published under the banner “Scotland’s pensions future” have successfully raised important issues on the implications of independence for the State pension, public sector pensions and private pensions.

Key points

The Pensions Committee recognises that the implementation of FRS 102 has generated significant changes to pension scheme financial statements and the considerable work undertaken by the SORP Working Party on behalf of PRAG to prepare the exposure draft.

We have answered each of the consultation questions and our responses are set out below. We are generally supportive of the proposed changes and highlight in our responses where we believe refinements to the proposed SORP would be desirable.

However, we have some comments to make generally about pension scheme financial statements beyond the scope of this current consultation. Pension Scheme financial statements are about the stewardship of members’ assets and we would welcome a broader discussion instigated by PRAG on how pension scheme financial statements could better demonstrate stewardship and could evolve to reflect developments which are on the way.

While not forming any conclusions about the recognition of pension liabilities and deficit recovery plan assets by pension schemes, we believe that this is a topic worthy of further discussion along with consideration of how these issues interact with pension related liabilities and assets recorded in the accounts of employers.

In terms of future developments, changes have been made to the FRSSE to include new requirements for micro-entities and further developments are expected in this area which will align requirements for small entities and micro-entities within a FRS 102-based framework. We believe that consideration should be given to how these developments could impact on the financial statements of smaller schemes. Also, with proposals for collective defined contribution (CDC) arrangements set out in a new Private Pensions Bill, further changes may be required fairly soon to address any implications for trust-based schemes operating on a CDC basis.

Any enquiries should be addressed to Christine Scott, Assistant Director, Charities and Pensions, at cscott@icas.org.uk.
Responses to consultation questions

Question 1 – Annuities. FRS 102 requires annuities to be reported at the amount of the related obligation. What practical issues do you see arising from this requirement? The draft SORP envisages the annuity value will be based on the trustee perspective of the related obligation and therefore most likely to be determined by the Scheme Actuary. Do you agree with this approach? (3.12.18 to 3.12.22)

Answer 1. We understand that under FRS 102 annuities must be reported at the amount of the related obligation. However, we do envisage that for some schemes, but by no means all, there will be some practical challenges and additional audit and actuarial costs as a result. It will be important for schemes to ensure that the necessary valuation information is obtained early enough for the production of the financial statements.

There will be challenges around the concepts of existence, ownership, completeness and valuation of these policies, including individual policies which while relatively small in value may be large in number with a combined value which is material.

Schemes may have lost track of some policies, for example, where payments are made by the insurer directly to the pensioner. In order to establish existence and ownership and to ensure a complete picture of scheme annuities, a considerable housekeeping exercise may be required by some schemes. We envisage that a revised audit practice note on the audit of pension schemes would need to provide additional guidance on the audit of annuities.

We have some reservations about the cost benefit of obtaining valuations set out in 3.12.22. These concerns are as follows:

- Accounting standards only apply to material items, so the question of whether annuities would be significant in relation to the Statement of Net Assets is a moot point.
- Accounting standard setters should normally consider the cost versus benefit of a particular requirement as part of the standard setting process so this could also be perceived as a moot point.
- Administrators may refer to the cost benefit test in 3.12.22 as a reason for not pursuing a housekeeping exercise but unless a housekeeping exercise is undertaken and annuities are valued, it may not be possible to determine if annuities are significant in relation to the Statement of Net Assets.

We believe that if annuities are material then these should be recognised in scheme financial statements and the only way to establish this is to undertake a housekeeping exercise and to place a value on the annuities, even if a proxy value is used to arrive at a view on the materiality of annuities.

The SORP says that the basis for valuing annuities should reflect the circumstances and purpose of the annuity arrangements. For example, if the intention is to hold the annuities for the long term the scheme funding valuation would seem the most appropriate basis to use but where annuities have been purchased with a view to “moving to buy-out” then the buy-out basis may be more appropriate. As the aim of most schemes is ultimately to buy out, we would welcome guidance in the SORP on what the triggers would be for recognising a change in the valuation basis where the SORP refers to “moving to buy-out”.

Question 2 - Investment risk disclosures. Has the draft SORP taken the right approach to risk disclosures? (Section 3.16). In particular is the approach to pooled investment vehicles and the look through and asset classes approaches considered appropriate? (3.16.1 to 3.16.5). Is the approach to direct credit risk for pooled investment vehicles, which recommends disclosing an analysis of types of pooled vehicles held, appropriate? (3.16.10 to 3.16.13). Are there alternative approaches that could be considered?

Answer 2. On the whole, we are supportive of the risk disclosures proposed in the exposure draft.

Traditionally investment risk disclosures have been reported in the other material accompanying the financial statements and trustees should therefore ensure that any duplication of information between the investment commentary and the financial statements is kept to a minimum. However, we would welcome a greater steer in the SORP on the distinction between the content of the investment commentary and the investment risk disclosures.
We envisage that auditors will undertake a consistency check between the investment commentary which sets out a scheme’s investment strategy and the investment risk disclosures in the financial statements and that this would be covered in a revised audit practice note.

We believe that the new investment risk disclosures could provide an impetus to administrators to tailor investment reports to scheme specific circumstances and we would welcome such a development. However, we recognise that this will only be achieved through dialogue between schemes and their administrators.

In respect of tailoring, we believe that there is further scope to refine the investment risk disclosures by placing an emphasis on those investments which schemes are tied into for the long-term.

In respect of pooled investment vehicles we agree that disclosures should reflect the trustees’ intentions. However, we are concerned that it may not always be possible to determine the intention of the trustees with a sufficient degree of certainty. Therefore, we believe that unless the trustees can demonstrate a clear positive intention to hold units in a pooled investment vehicle to gain exposure to underlying assets classes, the look through approach should not be followed.

In terms of the practicalities of complying with the investment risk disclosures, obtaining the required information is likely to create some challenges.

It is not certain that all investment houses will be able to produce the necessary information and produce it in a consistent form, for example, it could be that some overseas investment houses may not be able to do this.

We also believe that the information provided by investment houses on pooled investment vehicles where the look through approach is being used has the potential to be confusing and therefore may lend itself to a different interpretation by the scheme. In such circumstances it may be difficult for the scheme auditor to verify the disclosures without undue cost and time. The exposure draft points out that where information is not readily available reasonable estimates should be made and where estimates have been used this should be disclosed. We have some concerns about what the basis would be for these estimates, how meaningful the estimates would be and how both the scheme and the scheme auditor would assess their reasonableness given the complexity of some pooled investment vehicles.

**Question 3 – Fair value hierarchy.** Is the distinction of investments valued using a valuation approach (Category C investments) between those using market observable data (C(i)) and non-observable data (C(iii)) considered helpful? (3.12.8 to 3.12.10).

**Answer 3.** We support the approach taken in the SORP to the fair value hierarchy. This is a practical approach to the differences in classification between IFRS and FRS 102. We also agree that the Pensions SORP should be consistent with the Authorised Funds SORP produced by IMA.

**Question 4 – Financial statement presentation.** Do the example financial statements provide sufficient practical guidance on the application of the draft SORP’s new disclosures? Is the alternative combined presentation of investment risk and derivative notes to the example financial statements helpful? Is having a choice of examples helpful? Are there better alternative approaches?

**Answer 4 -** We agree that the illustrative financial statements strike the correct balance between being helpful while aiming to ensure that the scheme financial statements do not become boiler plate.

It will be incumbent on schemes to determine how they wish to present their financial statements, within the constraints of the SORP, FRS 102 and the Regulations, and this task will need to be undertaken on a timely basis, so that software providers can respond to any demand for alternative approaches to presentation.

The committee had mixed views on the disclosure of direct transaction costs which are recommended in paragraph 3.8.42. Where concerns were raised these were over the level of additional work which would be required to identify direct transaction costs relative to the costs themselves. However, the direction of travel is towards increased transparency and on balance we understand and accept the recommendation.
In respect of trust-based DC schemes, what is really important from the members’ perspective is that contributions have been received and invested by the scheme completely and on a timely basis. If good practice guidance is to follow the publication of the SORP, we would welcome the development of a disclosure which illustrates this point.

**Question 5 - Auto-enrolment.** Do you agree with PRAG’s view that the legislative disclosure requirements in relation to accounting for the first contribution arising from employees are auto-enrolled? (3.8.2)

**Answer 5.** We agree that the approach proposed by PRAG is technically correct. However, we do not believe that the impact of a different treatment would be material to a scheme’s financial statements. In view of this, it may be more practical to permit an alternative treatment, i.e. permit refunds of first contributions to be accounted for on a net basis.

**Question 6 – Legislative disclosure requirements.** Do you agree with PRAG’s view that the legislative disclosure requirements in relation to investment classification as set out in the Audited Accounts Regulations are updated to come into line with FRS 102 and the draft SORP? (Appendix 7)

**Answer 6.** Yes. We agree that the legislative disclosure requirements should be updated to come into line with FRS 102.

**Question 7 – Concentration of investments.** In addition to the detailed investment classification disclosures referred to above, the Audited Accounts Regulations also require the disclosure of any investment (other than UK Government securities) in which more than 5% of the total value of the net assets of the scheme is invested. Do you think this disclosure is necessary in light of the risk disclosures required by FRS 102 (section 3.15) and the separate requirement to disclose employer related investments (section 3.32)? If you think it is required should it apply to investments in pooled investment vehicles at unit level or should investments held indirectly through pooled investment vehicles be taken into account (the “look through approach”)?

**Answer 7.** We would not support the removal of this disclosure requirement from the Audited Accounts Regulations. While we support on the whole the risk disclosures and the disclosure of employer related investments arising from FRS 102, we do not believe that these disclosures make the concentration of investment disclosures unnecessary or consider these to represent duplication.

Where investments in pooled investment vehicles are held for their exposure to underlying asset classes, we believe that the look through approach should be followed in concentration of investment disclosure. Our response to this part of question 7 is caveated by our comments on question 2 about the treatment of pooled investment vehicles.