ICAEW representation

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

ICAEW REP 47/06

PENSIONS: FORM AND CONTENT OF SCHEME REPORTS & ACCOUNTS

Memorandum of comment submitted in August 2006 to the Pensions Regulator in response to its discussion paper on the form and content of pension scheme annual report and accounts

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INTRODUCTION

The Institute of Chartered Accountants in England & Wales (ICAEW) welcomes the opportunity to comment on the discussion paper issued by the Pensions Regulator 'A review of the form and content of pension scheme annual report and accounts' available at:
http://www.thepensionregulator.gov.uk/mediacentre/pressreleases/pn06/pn06-20.aspx.

This paper has been discussed by the pensions accounting group of the ICAEW's Financial Reporting Committee and by the ICAEW's Pensions sub-committee, and incorporates the comments of other ICAEW members who have submitted responses to the ICAEW for consideration. Since the views of the Institute's membership were not unanimous, the paper presents some alternative opinions in relation to certain questions.

SUMMARY OF MAIN COMMENTS

Scheme annual reports and accounts generally have very limited readership. Few schemes circulate them to scheme members automatically and very few scheme members actually ask for and read them. As a result, some of the commentators feel that there should be some focus on how to persuade people to take an interest, and that reviewing the content should be examined in this context. It was also considered that trustees should be encouraged to explore alternative means of communication with scheme members, perhaps through AGMs or roadshows.

ICAEW members would like to see a greater emphasis on trustees being required to report on the overall performance of pension schemes including the funding status and plan. Much of the current content is laid down by regulation and does little to add to the reader's understanding of the scheme. It was agreed that it was desirable to have better and wider disclosures of how the trustees discharge their role and their compliance with the law and, like directors of listed companies, trustees should provide a comprehensive review of activities, preferably at the beginning of the annual report.

The annual report was not designed to be used by regulators. If the reports were to be routinely used in this way there might be an argument for introducing a filing requirement and making the reports publicly available. The general consensus was that this was not necessarily desirable and that the primary objective of the report should be on providing comprehensible information to scheme members on whose behalf contributions are made and who almost always contribute themselves.

It was considered that the annual report requirements provide a reasonable framework but that the information in it should be focussed on the question of whether the scheme member is going to receive his/her pension. As such, scheme members need to know:-

- the strength of the employer's covenant, coupled with
- how well the managers are performing and the security of the investments;

- the level of the liabilities and details of any recovery plan; and
- how well the trustees are running the scheme.

We debated at some length the purpose of pension scheme accounts and whether or not liabilities to provide pensions should be included within the accounts. We are conscious of the considerable additional expense of including actuarial liabilities in the accounts. As a result, it is not clear that the benefit of including the information in the scheme accounts - as opposed to including it in the trustees' report or in an actuarial statement within the annual report - would exceed the cost of doing so.

Overall, the consensus was that the accounts should continue to reflect the record of stewardship of the trustees, with information about pension liabilities being dealt with in an actuary's statement. This statement, rather than being dropped, should be improved to make the position clearer to scheme members. The trustees in their report should provide an overview of the position shown by the accounts and the actuarial statement.

Whilst the majority view was that the inclusion of actuarial liabilities in scheme accounts was not recommended, opinion was divided. If they were to be included, then it would be logical to use:

- the scheme-specific funding basis, which would include taking into account the scheme's circumstances eg whether or not it was closed or frozen; or
- an FRS 17/IAS 19-related basis, with an explanation that this is the basis on which the employer must report it, and of the major reasons for the difference as trustees do not manage their schemes on the basis of these calculations; and
- an explanation of the reduction in benefits if the scheme were to go into the PPF, and the circumstances in which that would happen rather than the discontinuance basis valuation.

It was observed that the Swiss had recently introduced a requirement to include actuarial liabilities and this was being done on a scheme-specific basis.

Notwithstanding the lack of agreement over inclusion of actuarial liabilities in scheme accounts, there was consensus that there should be more actuarial information in the annual report, including some detail of any recovery plan. One suggested approach was that there should be cash flow information showing how the anticipated inflows and outflows have an impact on the longer-term ability to pay the promised pensions, looking at the expected cash outflows over the life of the scheme, the existing assets, the impact of the employer continuing to contribute to cover current service cost and any agreed additional contributions. This would be accompanied by information on what the return on assets needed to be to cover the outflows with the historic and current forecast of returns. Such information could be subjected to sensitivity analysis across a range of assumptions and show how quickly any deficit was being funded. This would tie in with in the need for information on the strength of the covenant and investments.

Finally, if the Pensions Regulator is to place reliance on the fact that the annual report is subject to audit, it must recognise that the auditor's responsibilities only cover the financial statements. The auditor's only responsibilities in respect of the rest of the annual report are to highlight any inconsistencies with the audited financial statements.

RESPONSES TO INDIVIDUAL QUESTIONS

1) Do you agree with our analysis of the relative strengths and shortcomings of the annual report? If not, why not?

Generally we agree with the analysis. The annual report is a valuable record of the scheme's financial transactions in the year, its assets and liabilities at the end of the year and the trustees' stewardship thereof, but fails as a means of communication with scheme members. They only want to know what their pension will be and, increasingly in the light of scheme failures, whether it will be safe. We do not believe that most scheme members bother to read the accounts. Professionals may well use the accounts but most scheme members do not have the knowledge to interpret accounts and understand what the implications are.

If the annual report is to be the principal means of conveying information to scheme members, it will need to focus much more on providing information on how the trustees are going to pay the promised pensions.

Information about the long term liabilities of a scheme is currently best obtained from the actuarial valuation report, which is available to members on request, but some information needs to be included in the annual report in the context of giving members a picture of the overall financial health of the scheme.

2) Do you agree with our analysis of the relative strengths and shortcomings of pension scheme accounts? If not, why not?

We agree with the Pensions Regulator's analysis but believe that financial statements prepared in accordance with the SORP meet the present statutory reporting requirements. It is recognised that the accounts do not inform the members of the security of members' benefits, but in our view it is difficult to see what could be changed in respect of the shortcomings. No one can predict the future, and attempts to provide the big picture on security may be misleading. In many cases, the biggest issue is the failure of the employer and this is notoriously difficult to predict over any reasonable period.

3) Do you agree with our analysis of the relative strengths and shortcomings of summary financial statements? If not, why not?

and

4) Do you agree with our analysis of the relative strengths and shortcomings of summary financial information for members? If not, why not?

The discussion paper refers variously to "summary financial statements" and "summary financial information". We assume the distinction is that summary financial statements are those that have been audited. We note the SORP guidance is intended to help preparers of summary financial statements and information, but there is no audit requirement, nor any requirement to even show the summary financial information/statements to the auditor before they are distributed. We also note on a practical level that Practice Note 15 (PN 15) issued by the Auditing Practices Board is not aimed at summary financial information. In our experience, auditors are very rarely engaged to review summary financial statements. It has been represented to us that audited summary financial statements are deemed unnecessary and if they were to be in a prescriptive format, the summary might become too detailed, defeating the object of the exercise.

In the light of the comments above, we respond to these questions together.

We agree with the analysis but the question is whether the annual accounts are the appropriate vehicle to address the issues. Most scheme members will not understand accounts. They simply do not have the financial knowledge, regardless of the amount of information which is included. Most simply wish to know what their pension is and whether it is safe. If someone provides this in a two-line letter, and they have the option to look at the underlying accounts if they wish, then they will be satisfied.

Having said this, our respondents felt that the use of summary information will meet the needs of members if it is accessible, checked for consistency against source documents and contains adequate disclosure concerning funding and security of pensions. It provides a good mechanism for communicating with members in a cost effective way. The emphasis should be on improving the quality of such statements and the majority view was that this is probably best achieved through example, rather than regulation.

Research carried out by the Pensions Research Accountants Group (PRAG) shows that, where schemes do produce them, the content and quality varies considerably. This would suggest that there is an argument for having some standards for summary reporting. There was also a minority view that summary reporting should be required so that scheme members receive some scheme information with their individual benefit statement and the scheme funding summary.

There is a need for further guidance in this area and a Guidance or Briefing note issued by the Pensions Regulator is perhaps the best medium.

5) Are we correct in our assessment here that the onus should shift from comprehensive disclosure in the scheme return to a more prescriptive set of disclosures in the scheme report and accounts?

As noted in the introductory remarks, the needs of the trustees, scheme members and regulator are likely to be different. Information the Pensions Regulator feels necessary should only be included in the annual report to the extent relevant to other users.

Any change which avoids duplication of effort is welcomed but needs to take account of the primary use of the annual report. The scheme return need not ask for information already required in the annual report.

If the Pensions Regulator were to require a shift of emphasis to the report and accounts as the primary source of information for all other disclosures, the scheme return should be limited to information required by statute.

6) For DB members, will the Annual Benefit Statement alone (in its proposed form) provide members with enough information to make an informed choice about their pension provision or is more information required? And if so, where should this information be given?

We believe that the annual benefit statement ("ABS") alone would be adequate.

We note that the ABS will be a significant administrative burden for many schemes, especially those with a large number of deferred members. In addition, the ABSs are likely to generate further queries from scheme members.

Many schemes are likely to take the opportunity of combining the ABS with the Summary Funding Statement and perhaps information on the scheme as a whole and this may be the most sensible route for setting some standards on summary reporting. Indeed, we are aware that a number of schemes have already adopted this approach.

7) For DB members, will the Summary Funding Statement (in its proposed form) provide members with enough information to appreciate the level to which the scheme is funded or is more information required? If so, where should this information be given?

We believe that the scheme funding statement will satisfy this requirement. It is a communication challenge to present funding information in a meaningful and understandable way. Our respondents have commented that they are not sure what the Summary Funding Statement will achieve that could not be dealt with by including the summary information in a high quality annual report and accounts (or summary thereof) when sent together with an annual benefits statement. The requirement for a Summary Funding Statement seems to be an example of a lack of joined up thinking at best or an unnecessary regulatory requirement.

8) For members of DC schemes, does the Statutory Money Purchase Illustration (SMPI) fully meet the member's information needs concerning the 'value' of the fund administered on their behalf?

It might be argued that information as to how a member's scheme has performed by comparison against its peers is irrelevant as the member is unlikely to be in a position to switch, but the alternative view is that employers and members need to know whether their funds are performing badly and whether the trustees have reviewed the position. Information against relevant benchmarks for a member's own funds and all others offered by the trustees should be given. The benchmarks should include inflation and perhaps general market indices relevant to the specific investments.

We do not believe anyone will object to more information of a comparative performance nature.

9) Is the 'one size fits all' solution of (unabbreviated) report and accounts to all members a proportionate approach to take?

It is important that a member of a small scheme has the same access to information as a member of a larger scheme. There should thus not be any exemptions for any scheme except perhaps where all members are trustees and are involved in all decision making. Additional comments are as follows.

Whilst the full annual report and accounts of a pension scheme should be available to all members of a scheme, as noted above, we do not believe that there is any appetite from scheme members to receive the full annual report and the majority of scheme members will not gain any added value from a full set of accounts. If they are provided with a summary report and have access to the full accounts at their request, then this should suffice. In addition, the costs of compulsory provision of the full annual report would be excessive and it removes the trustees' discretion as to what to disclose and how to communicate to members.

The decision to produce summary financial statements or information should continue to rest with the trustees (it should not be a mandatory requirement).

In respect of the suggestion that a potential drawback might be that deferred members might be hard to track down, we recognise the difficulties of keeping in touch with such members, but believe that this is completely irrelevant in the context of a decision about whether to have full or summary financial statements.

10) Recognising the clear differences between pension schemes and charities is there some merit in drawing on certain aspects of best practice in good governance for trustee bodies in the not-for-profit sector?

Yes, there would be merit in drawing on the detail in the Charities SORP for pension schemes. Whilst recognising that the pension sector is unique with trustees probably being responsible for the principal income of scheme members in retirement, we are strongly supportive of the need for a governance statement and of the merit in drawing on certain aspects of best practice from the charitable and, indeed, the corporate, sectors.

11) How relevant is a governance statement for members, particularly in respect of risk assessment and internal controls?

It is relevant to charities and they face the same governance issues, so in our view it should also be relevant for pension schemes. Scheme members will look for regular assurance that their fund is being properly managed and this may influence their decision as to whether to join or not or continue as a scheme member. The vast majority of scheme members are unlikely to be interested in too much detail.

We view a governance statement as important in giving scheme members comfort that the scheme is being run properly on their behalf. We felt that concerns about the boilerplate nature of such statements were unfounded – a boilerplate statement is perfectly accepted, indeed desirable, provided it is meaningful and true.

We would be concerned if trustees were to be asked to give an opinion on the effectiveness of internal controls. Such an approach would be in stark contrast to the duties of PLC directors as set out in the Combined Code and particularly the Turnbull Guidelines. PLC directors have a duty to describe the process for identifying, evaluating and managing risks and stating that it has been reviewed, but they are not required to give a statement on the effectiveness of that system. It would be invidious if trustees were to be put in a more onerous position than PLC directors.

Indeed, inclusion of any comments as to the effectiveness of internal controls could cause considerable difficulty. Trustees usually outsource most processes and are likely to be unwilling to give any assurances without reports from third parties, which might be costly to obtain. Nevertheless, the trustees are responsible for the effective operation of the scheme and should be explaining to scheme members how they obtain their own comfort on the internal controls of third parties. A governance statement would help interested scheme members in the context of whether the pensions promise is likely to be met.

12) Do you consider that removal of miscellaneous compliance disclosures (the compliance statement) as a compensatory measure for inclusion of a governance statement provides the appropriate balance of disclosure?

Current disclosures in the compliance statement are very easy to obtain and review and so have minimal cost. We agree that unnecessary disclosures should be removed, but would question the assertion that there would be significant cost savings as a result. The real cost savings will, in our view, come from rationalising the number of separate returns required overall.

Schemes already relegate miscellaneous compliance information to the back of the annual report. There should be a comprehensive review of whether all the currently compulsory information remains necessary and in this respect the recent decision of the Department for Work and Pensions not to reissue the Disclosure Regulations (that had been proposed to be done this Autumn) is disappointing.

13) Would the inclusion of actuarial liabilities within the primary financial statements of the scheme add value to the reader?

As we have noted in our introductory remarks, we did not on balance think that the inclusion of actuarial liabilities within the primary financial statements adds value. Funding information needs to be provided but need not be done through the financial statements.
Instead, we are of the view that the trustees' report should bring together the asset and liability sides of the equation.

This is a very contentious matter and a number of respondents believe that actuarial liabilities should be included in annual accounts intended to give a true and fair view under accounting standards. If scheme accounts were to continue excluding benefit liabilities, it would need to be clear how this was possible under the EU Pensions Directives and it would be helpful if the legislation were changed to require pension scheme accounts to be properly prepared in accordance with a specified basis, rather than giving a true and fair view excluding benefits.

Scheme members undoubtedly need better information as to the level of funding in their scheme but opinion differs as to whether the inclusion of actuarial liabilities in the primary statements would be useful. The measurement on an annual basis might be costly and time consuming.

Scheme members may already be aware of actuarial valuations of liabilities done on a scheme specific funding basis (or MFR basis), on a buy-out basis and on an FRS 17 / IAS 19 basis and yet another figure for the liabilities would add to the present confusion.

As noted in our introductory comments, if actuarial liabilities were to be included, there would then need to be a whole separate debate about the basis of measurement that should be adopted, including the treatment of future pay rises and discretionary benefits. We would question whether the snapshot approach of, for example, FRS17 / IAS19 is of any real value to members of a pension scheme who want assurance that their current pension will continue to be paid or that there will be sufficient funds to meet the commitments made to them many years in the future.

PRAG is recognised by the Accounting Standards Board (ASB) as the appropriate body within the pensions industry for issuing statements of recommended practice (SORP) governing the form and content of financial statements for pension schemes. It was suggested that this should be a matter for the PRAG SORP working party to consider and further debate should await the outcome of the current work being undertaken by the Accounting ASB on pensions accounting.

14) Do you agree that there would be a significant additional cost from the inclusion of the actuarial liabilities on the face of the net assets statement or in the notes and, if so, do you think the benefits outweigh the cost?

It is likely that not all of those currently auditing pension schemes will have the necessary skills to audit actuarial calculations and the generally held view is that their inclusion would substantially increase audit costs for little benefit.

Whilst there would undoubtedly be significant extra costs involved, the question is really one of principle first and being very clear about the purpose of the financial statements of pension schemes. Whether actuarial liabilities should be included and on what basis follows from that debate. As noted under question 13 above, this is currently under consideration.

15) For DB scheme members, is the right place for disclosure of information on funding and the employer covenant in the financial statements of the pension scheme or can existing disclosure mechanisms (including the summary funding statement) be further developed to meet this need?

Generally, commentators believe that the annual report should disclose the funding and employer covenant but this is not a unanimous view. The compulsory summary funding statement is a vehicle for trustees to give members additional information, and it is recommended that the information on the funding statement should be summarised in the trustees' report within the annual report.

Whilst the inclusion of information in the annual report is useful, it is not an effective means of communication because, as we explain in our introductory comments, few members currently actually read the report.

There were significant concerns about any discussion of the employer covenant in the financial statements of a pension scheme. There is at present little established methodology for measuring the strength of the covenant and there is a potentially huge sensitivity to any disclosure – in particular, an expression of concern by the trustees could be extremely price sensitive for a listed group and, worse, could lead to a self fulfilling prophecy. In such circumstances, the trustees could face legal challenge from both the members of the scheme and shareholders.

As regards the PPF solvency score, we are concerned that the sensitivity of the score to small changes in the Dun & Bradstreet assessment is not widely understood, and neither is the fact that real risk of insolvency is limited to a very small number of employers with very low solvency scores. For example, there is only around a 5% increase in the risk of insolvency when moving from a score of 100 to one of 30. In addition, the assessments of insolvency risk are undertaken on a relatively short-term basis whereas the trustees should be looking at much longer timescales.

Any disclosures on the strength of the employer covenant are likely to be bland and employers are likely to be less open with trustees if they think information is likely to be published. Scheme members will want to know that the trustees are monitoring the situation and therefore we believe that this is much more relevant.

16) Should the recovery plan be included in the report and accounts (in full or in summary) or should these simply be signposted in the financial statements?

There was a general consensus that scheme members will want to know that there is a recovery plan and that it is being followed. They are unlikely to want to know the details but a brief summary would be useful. Guidance should be produced setting out minimum disclosures. We cannot see why a recovery plan cannot be adequately expressed in sufficient detail to be understood in a few paragraphs. The scheme auditors continue to provide an opinion of contributions, and reference to their statement is also appropriate in this context.

Whether the recovery plan is reproduced in full or whether an abbreviated form is provided is a matter that should be left to the trustees. The requirement should be that they explain any recovery plan that they have adopted and the test is whether a reader can understand what it is that the trustees are doing.

17) For DC schemes, do you anticipate practical difficulties in shifting the emphasis from a generic investment report to a more focused disclosure in the trustees' annual report?

No. Where DC schemes use a manager's funds which are designed to track indices, a generic investment report is acceptable. A more focused investment strategy should lead to more focused disclosures so that a scheme member can understand what the manager has done and what the impacts have been.

The position as regards individual scheme members is best dealt with in their benefit statements.

Note that DB members also seek detailed investment information, since investment performance, coupled with the strength of the employer covenant, is also important in assessing whether the pension promise is to be met.

The Pensions Regulator seems to suggest that transparency and access to comprehensive information might not be a good thing. We believe that it would be reprehensible and unacceptable if the regulator were seen to be suggesting that members of DC schemes should not receive comprehensive information. If access to information deters people from investing in DC pensions, then the factors that are putting them off need to be explored and understood, not hidden.

18) Given the importance of good governance, should any exemptions apply to smaller occupational pension schemes and if so, are limits, based on the number of members, appropriate?

No, we believe that members of smaller schemes need the same information as those of larger schemes and that the number of members is irrelevant to the needs of individuals. The only schemes where exemptions might be appropriate are where the trustees are the scheme members and are looking after their own investments rather than those of others.

For DC schemes the challenge for trustees is to ensure that, between the annual report and accounts and the statutory money purchase illustration, members of the scheme have the information they need to manage their own positions. This might require some intellectual rigour, but should not present an insurmountable challenge.

In respect of <u>all</u> the above:

QUESTION: These proposals have been prepared on the assumption (other than for the inclusion of actuarial liabilities on the face of the primary statements) that they would be cost neutral. What in your opinion (based on your own experience and scheme size) are the cost implications of each of these proposals, is there an associated benefit that would justify any additional cost and are there either compensatory cost savings or intangible benefits?

As detailed above, more information will inevitably cost more to produce and the intangible benefits are difficult to quantify.

Apart from the costs relating to the inclusion of actuarial liabilities, most other proposals would involve only a marginal increase in costs and are likely to result on better information and communication and are therefore justified.

<u>OTHER COMMENTS ON THE DETAIL OF THE PAPER</u>

<u>Paragraph 2.16</u> – the sentence on good administration procedures is out of context or needs more amplification.

Paragraph 3.5 – governance costs can be quite high.

Paragraph 3.17 – please amplify the disclosures which you think should be on a common basis.

Paragraph 3.19 – this was thought unlikely.

Paragraph 6.2 – it is not the audited accounts which show whether the funds match the SIP but a comparison of the two which would do so, and the accounts do not necessarily show whether expenses are reasonable. It is the auditor's statement which shows whether contributions have been paid over in accordance with the schedule.

Paragraph 6.5 – is the regulator happy to operate a risk-based approach? Auditors only review other information in the annual report from a perspective of consistency with the financial statements, so there is no full audit of the information's accuracy. Also, the level of detail on the returns is quite considerable – do we really want annual reports to turn into data for the Pensions Regulator?

Paragraphs 6.7 and 6.8 – some schemes have given out annual benefits statements for some time so it would be worth talking to some pension managers about their experiences. The scheme funding statement is new and, again, worth discussing with pension scheme trustees and managers to see what they have said and what the response has been.

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