Discussion of ‘The logic of pension accounting’

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Professor Napier’s paper provides a helpful tour through 40 years of pensions accounting – far less than the run-off time for the average pension, of course.

Users of accounts (investors and analysts) are fascinated by pensions, partly because from the perspective of a sell-side analyst many institutional clients are ultimately funded by pension trustees, so there is a slightly bizarre circularity in the whole thing. A second, even stranger circularity is the fact that a fund manager running a pension fund for a large scheme such as the British Telecom pension scheme, will be investing in companies like Aga, who have pension schemes which are about 10 times the size of the company’s market capitalisation. They are therefore investing in the efforts of their competitors in many cases.

Investors and analysts need information about pension schemes but the key question is: what is it that investors and analysts actually want from accounting, and from pensions disclosures?

I think there are four areas that investors and analysts look at.

1. They want to know about the liabilities arising from the promise to pay pensions in the future.
2. They want to know about any assets that are there to hedge or try and cover those liabilities.
3. They want to see some impact in terms of the profit and loss account, the way the company’s performance is affected by the promise that it is making to its workers.
4. They also want to have an understanding of the cash flows associated with those promises.

Now in terms of the liability, I would agree entirely with what Napier says in his paper – what analysts are interested in is some sort of present value estimate. We want analysis in ‘today’s-money-terms’ of what the liability amounts to. Now that is clearly going to be very difficult. Analysts are perfectly well aware of the difficulties of estimating things that are very long-term. We spend our lives trying to estimate the value of companies, which involves forecasting in perpetuity. Pension liabilities are a mere sneeze in that sort of context. So we are perfectly happy that things are uncertain, and we are quite happy to manage that; but fundamentally we want a present value version of the liability.

Now that, of course, immediately begs two questions, which Napier dealt with in some detail.

1. What is the discount rate?
2. To what extent should you take account of the fact that the promise you make now is affected by promises you are going to make in the future?

Of course we don’t book future salaries, because they are not promised. But when you make a pension promise you are promising that if you make a future salary rise, you then will add a pension on top. It is not as simple as saying: ‘But we have not promised it yet’, because in a way you have done so. There is a debate to be had here, and I do not think there is an easy answer.

First is the discount rate, and I think there is an easy answer to this one. It’s one that companies don’t like and it’s simple: use a risk-free discount rate. It’s clean, it’s simple, it’s wrong, but it’s straightforward! Any other discount rate is also wrong, so none of them is any good. We might as well have at least one that is clean of so much noise. If you look at what we are using at the moment, which is by and large the IBOX AA discount rate, it stands close to 7% at the time of writing, more than 200 basis points over the government rate – massively distorted by the fear that is currently in the credit markets. This results in an accounting liability which, for some companies from December 2007 to now, could have shrunk by 40% using an AA rate. That is complete nonsense, particularly when you talk to the trustees, and they say, ‘Oh, no, the liability has increased.’ Who decides the cash – the AA rate or the trustee? The trustee – I should like to know more about the trustees’ view, and the cash demands that might result.

We need to get rid of some of these discount rate distortions. We are where we are in pensions ac-
counting because we vacillated for 25 years with the discount rate. If we had sensible discount rates, we wouldn’t have gold-plated civil service pensions! Let us just have a nice, clean and simple risk-free rate and let us try to capture the uncertainties in the way we estimate the future cash flows, including things like longevity, but let us not have the discount rate debate.

That does not solve the salary debate, and I am in two minds here. I think my fundamental stance is that the company is on the hook for current salaries and the pensions related to that – because it always does, in almost all circumstances, have the option of just saying, ‘Well, we will keep you employed, but we will stop your pensionable salary going up’ – again, slightly depending upon legal environments around the world. You can capture that by saying, ‘What is your legal obligation?’ But it’s very useful to know in an ongoing company, if it carries on behaving in this way, what is its ultimate run-off liability? It is clearly bigger than that from closing everything and ceasing business now. Again, I would agree with Napier’s point that complicated situations require complicated disclosures. I don’t think we can get round that, and unfortunately, in many respects, we do not have enough disclosure around pension liabilities.

That provides a couple of small points on the liability itself. In terms of the assets: I support current market values absolutely. The only circumstance where I would slightly veer away from that, is if you have bought an annuity which directly covers a specific portion of your scheme on either a single name basis or just a portfolio, but covering all these people, and you’ve a comprehensive hedge. Under those circumstances it makes economic sense to me to see the liability and the asset moving in line. I would say: ‘Let’s measure the liability and just say the asset must match that’ and not bother trying to work out some theoretical fair value for the annuity. That seems to be what companies are currently doing in their accounting disclosures – companies like Cable & Wireless, where they have carried out a partial buy-out. That seems to me to be perfectly sensible, because it conveys a reasonable understanding of the economics.

What about the income statement? The income statement is significantly more difficult. What we want to see in the income statement is that here is a company with a pension scheme that arguably should be paying a lower cash salary to its employees because it is giving them something else instead. So you would expect to see some sort of entry in the income statement reflecting the fact that you have given them a cash salary today and a valuable promise that will pay out in the future.

Now working out exactly what goes into the income statement is clearly quite difficult, but I think the current service cost going above the EBITDA (earnings before interest, taxation, dividends and amortisation) line within operating expenses seems to me to be fairly logical, and I am reasonably satisfied with the way current accounting standards work in terms of giving me that sort of number.

Napier highlighted the other side of the equation, which concerns these financial entries. This, clearly, is where there is a much bigger problem. We want to see – or we are forced to see, really – an unwinding of the discount, some sort of implicit interest cost related to the liability. We must have that just to make the maths work. That also suggests that you must then take account of what is happening on the asset side.

Again, I take Napier’s purist point that companies should just book the value changes, and essentially agree with it until I see what it actually gives me in practice. Because it gives me potentially massive volatility that completely outweighs what’s going on operationally with that company. And it does create a distorted view of the actual cash economics because the economics of a pension scheme are that you can actually pay it off over 40, 50, 60, 70 years. It really is very long-term and you really don’t have to settle it all at once. So the fact that your equities have taken a big hit this year is not pleasant, but it doesn’t necessarily turn into a £20bn cash payment at the end of the year. We must try to find some way of balancing those two conflicting issues.

Essentially, what we are coming up against is the fact that accounting does not deal well with things that run on for more than about five years: that’s the fundamental issue. And if you were to look at any company with a pension liability, it will have five-to-ten-year duration liabilities in terms of its borrowings and then it will have a significant long-duration liability in terms of the pension scheme. It’s completely different to anything they’ve got. We need to reflect those issues, and we have to find some way round the income statement issue.

One solution the IASB has suggested, which I’m reasonably in favour of as a pragmatic approximation, is effectively to credit the assets in the scheme with the same returns as I am charging interest on the liabilities. If the liabilities are being charged at AA discount rate, then I would just assume the assets are generating that – to effectively achieve an offset in the income statement. If you want to look at it another way, what that gives you is, in essence, an interest charge on the deficit. Clearly, that has no direct relationship to cash – it is a made-up number – but it seems to me to be a slightly more useful made-up number than what we have at the moment, which is completely made up. This approach would be slightly less open to
manipulation and is one favoured by a number of investors – and then we could deal with the rest of the volatility through the STRGL. That’s not purist accounting, but it seems to me a slightly more pragmatic way of trying to deal with the fact that we’ve got different elements which are giving us different information. That’s one possible solution.

In terms of cash flow, clearly what you have here in a UK context, is an actual smoothing process. The trustees meet every three years, they decide what they are owed, and then they decide how quickly they can reclaim it. In periods of stress such as we are experiencing at the moment, they extend the pay-back period (they don’t shorten it, because they stand at the back of the insolvency queue). The trustees are absolutely not going to push a company into insolvency because they stand at the back of the queue. So they’re going to give it more leeway. There is smoothing occurring in real cash-flow terms, and that is informative to the market. That changes the risk dynamic.

What do we need to know that we don’t know at the moment? We clearly need to know what the trustees know; we need to know the actuarial valuation. We need to know their view of the liability. That, for most schemes, is completely opaque; we have no idea what that is. That is driving cash flows. We need to know what contributions they have agreed so far. Often we cannot find that information. We need to get a sense of what they might agree in the future. We need to know what their powers are. Can they unilaterally change what they want or do they have to go through a much longer process?

There are thus some very, very fundamental things that we just don’t know at all. All we are given is this AA discounted liability, and some-