

Section B – TWO questions ONLY to be attempted

- 2 (a) Accounting for retirement benefits remains one of the most challenging areas in financial reporting. The values being reported are significant, and the estimation of these values is complex and subjective. Standard setters and preparers of financial statements find it difficult to achieve a measure of consensus on the appropriate way to deal with the assets and costs involved. SSAP24 'Accounting for Pension Costs' focused on the profit and loss account, viewing retirement benefits as an operating expense. However, FRS17 'Retirement Benefits' concentrates on the balance sheet and the valuation of the pension fund. The philosophy and rationale of the two statements are fundamentally opposed.

Required:

- (i) Describe four key issues in the determination of the method of accounting for retirement benefits in respect of defined benefit plans; (6 marks)

- (ii) Discuss how FRS17 'Retirement Benefits' deals with these key issues and to what extent it provides solutions to the problems of accounting for retirement benefits. (8 marks)

- (b) A, a public limited company, operates a defined benefit pension scheme. A full actuarial valuation by an independent actuary revealed that the value of the pension liability at 31 May 2000 was £1,500 million. This was updated to 31 May 2001 by the actuary and the value of the pension liability at that date was £2,000 million. The pension scheme assets comprised mainly UK bonds and equities and the market value of these assets was as follows:

	31 May 2000	31 May 2001
	£m	£m
Fixed interest and index linked bonds (UK)	380	600
Equities (UK)	1,300	1,900
Other investments	290	450
	<u>1,970</u>	<u>2,950</u>

The pension scheme had been altered during the year with improved benefits arising for the employees and this alteration had been taken into account by the actuaries. The increase in the actuarial liability in respect of employee service in prior periods was £25 million (past service cost). The increase in the actuarial liability resulting from employee service in the current period was £70 million (current service cost).

The company had paid contributions of £60 million to the scheme during the period. The company expects its return on the pension scheme assets at 31 May 2001 to be £295 million and the interest on pension liabilities to be £230 million.

The company anticipates that a deferred tax liability will arise on the surplus in the scheme. Assume Corporation Tax is at a rate of 30 per cent.

Required:

- (i) Show the amount which will be shown as the net pension asset/pension reserve in the balance sheet of A plc as at 31 May 2001 under FRS17 'Retirement Benefits'; (comparative figures are not required). (4 marks)
- (ii) Show a reconciliation of the movement in the pension surplus during the year stating those amounts which would be charged to operating profit and the amounts which would be recognised in the Statement of Total Recognised Gains and Losses (STRGL), utilising FRS17 'Retirement Benefits'. (7 marks)

(25 marks)

- 2 (a) (i) There are many issues surrounding the determination of the method of accounting for retirement benefits. The main objectives of recent accounting standards internationally and FRS17 'Retirement Benefits' have been to ensure that the financial statements reflect the assets and liabilities (and changes in values therein) arising from an employer's retirement benefit obligations and that the respective operating costs are recognised in the accounting period. Thus one key issue is whether the accounting objective should be to view pensions as an operating expense and seek to provide for the projected cost over the pensioner's years of employment thus applying the matching concept and focusing on the profit and loss account or to concentrate on the balance sheet and use current values.

Other issues which require attention are as follows:

- (i) The determination of the pension expense: there is a need to establish an approach for the recognition and measurement of the retirement benefit expense. The question arises as to the method to be used. A cash or accruals basis could be adopted, or one based upon a funding objective whereby assets are built up in the scheme.
- (ii) Valuation of Plan Assets: the question arises as to whether plan assets should be recognised on the balance sheet as if the assets 'belong' to the company. This premise is questionable in law and in terms of economic reality. Additionally at what value should these assets be recognised. Various suggestions include market value approaches or fair values.
- (iii) Measurement of Plan liabilities: the scheme liabilities need to be valued using an actuarial or market value approach. As there is no active market for most defined benefit scheme liabilities, actuarial techniques have to be used. However, there are two alternative actuarial methods which could be used – the accrued benefits methods or prospective benefits methods. The main difference between them is the treatment of the time value of money.
- (iv) Frequency of actuarial valuations: the potential problem for companies is the onerous nature of such valuations and the impracticality for preparers of financial statements.
- (v) Recognition of actuarial gains and losses: the question arises as to whether these gains and losses should be recognised over the service lives of the employees or recorded in the Statement of Total Recognised Gains and Losses or recognised in the profit and loss account if they exceed a predetermined amount. The problem facing standard setters is how to deal with any volatility that may arise as a result of actuarial gains and losses.
- (vi) Plan amendments: the decision to improve benefits or award new benefits in relation to past service increases the scheme's liability immediately. The question arises as to how the cost should be recognised in the performance statements. The cost could be offset against any surplus in the scheme, or recognised over the remaining service lives of current employees or immediately recognised in the profit and loss account.

There are other issues which could be mentioned. For example the nature of any discount rate used, or the date of the actuarial valuation.

Candidates need only mention four of the above issues.

- (ii) FRS17 follows the views of the draft Statement of Principles by concentrating on a balance sheet perspective for retirement benefits and focusing on the use of current values. The surplus or deficit in the fund is to be determined annually with assets being measured at their fair value at the balance sheet date. The scheme liabilities should be measured on an actuarial basis using the projected unit credit method and a discount rate that reflects the time value of money and the characteristics of the liability. The rate can be assumed to be the rate of return on a high quality corporate bond of equivalent currency and term to the scheme liabilities. The net amount appears in the employer's balance sheet as an asset or liability.

Full actuarial valuations should occur at intervals not exceeding three years with the actuary reviewing the most recent actuarial valuation at the balance sheet date updating it to reflect current conditions. Actuarial gains and losses should be recognised in the STRGL. Past service costs should be recognised in the profit and loss account over the period in which the increases in benefit vest. If the benefits vest immediately, the past service cost should be recognised immediately.

However, FRS17 does not provide all of the solutions to the problem of accounting for retirement benefits. Under FRS17 companies are concerned about the volatile nature of pension charges in the profit and loss account in the form of the 'expected return on assets' as the higher the asset value of equities then the higher will be the 'expected return on assets' figure and since the equity market is volatile, so will the calculated return figure. The profit and loss account contains only estimated figures (current and past service cost and net returns on the pension scheme) with all experience gains being taken to STRGL. The effect is to report estimated numbers in the profit and loss account and variances from them in the STRGL, and because of the subjective and sensitive nature of these numbers, FRS17 leaves the door open for further manipulation of reported profits/losses.

(b) (i) Net pension assets/Pension reserve as at 31 May 2001

	£m
Fixed interest and index linked bonds	600
Equities	1,900
Other investments	450
	<u>2,950</u>
Actuarial value of liability	(2,000)
Surplus in pension scheme	950
Deferred tax liability (30%)	(285)
Net Pension asset	<u>665</u>

The opposite side of the balance sheet would show 'Pension Reserve' of the same amount. The long term rate of return expected on the pension assets would be individually disclosed.

(ii) Movement in surplus in the year

Surplus in scheme at 31 May 2000 (1970-1500)		470
Current service cost	(70)	
Past service cost	<u>(25)</u>	(95)
Contributions to the scheme		60
Net interest/return on assets (295-230)		65
Actuarial gain/loss (difference)		<u>450</u>
Surplus in pension scheme		<u>950</u>

The STRGL will show the actuarial gain for the year to 31 May 2001 of £450 million, and the operating profit will be charged with the current and past service costs of £95 million in total and the net interest/return on the assets of the pension scheme of £65 million will be shown as other finance income. The past service cost has been charged in full to the profit/loss account as the increased benefit has been vested.