



MARATHON CLUB STATEMENT

ISSUES REQUIRING CHANGES IN THE ACCOUNTING OF PENSION FUNDS

The IASB's announcement of 14 July of a review of mark-to-market accounting of financial assets and liabilities is welcome. However, the exposure draft (ED/2009/7) issued with the announcement is limited in scope to rectifying accounting problems in the banking sector. The Marathon Club is principally concerned with the insidious effects of mark-to-market accounting on pension funds, although the issues we raise apply more generally.

The exposure draft appears to make no change to the position in IAS 39 which equates the "fair value" of listed equities with current market value, whatever the market conditions. Should we assume therefore that the IASB retains faith in the efficient market hypothesis, despite the clear evidence against it? Does the IASB admit the existence of Benjamin Graham's intelligent investor looking for long term value, or does the IASB's world only consist of "strategic investors" and traders? And where in this world do pension funds belong?

The effect of having accounting rules which are so short-term in thinking has been to encourage companies (and regulators) to see pension funds in the same way, to their detriment. The Marathon Club believes that it is not beyond the wit of accountants to devise accounting rules which recognise the nature of pension funds as long-term investors with long-term liabilities. In this paper, we address the shortcomings we see in current accounting practice as applied to pension funds and we put forward suggestions for improvement. We encourage the accounting profession to join discussion with us.

Summary

Current International Accounting Standards for the valuation and reporting of pension fund assets and liabilities in the accounts of the sponsoring employer are based on two major requirements:

- (1) All assets must be marked to market value on the balance sheet date, unless they are intended to be held to maturity;
- (2) The net present value of all future liabilities, actual and contingent, must be discounted at a single rate determined by the yield at the balance sheet date of AA corporate bonds with a maturity equalling the duration of the pension fund's liabilities.

The Marathon Club believes that both requirements are inherently incompatible with the overriding principle of preparing accounts of a business as a going concern and are inadequate for the needs of the many different end-users of company accounts.

The Marathon Club also believes that current accounting standards are potentially misleading for the Pension Regulator, when evaluating its funding and recovery plan requirements.

The Marathon Club maintains that appropriate accounting should result in:

- 1) assets being shown at fair long-term values, and
- 2) liabilities being calculated as the net present value of future benefit commitments and other outgoings, discounted at a prudent long-term rate consistent with the valuation of the assets.



Rigid application of a mark-to-market approach does not produce fair long-term values for assets that will not need to be realised for many years into the future. Applying a single point-in-time discount rate, determined on market conditions at the date of the valuation, does not produce a reasonable estimate of liabilities, which will not crystallise until many years into the future.

The Marathon Club sets out below some issues that need to be resolved in order to establish accounting standards more appropriate and more relevant for the multiple end-users of accounts - shareholders, pension fund members and regulators. The Marathon Club will be happy to consult with major accounting firms and other interested parties in working towards a more satisfactory accounting and reporting regime.



Commentary

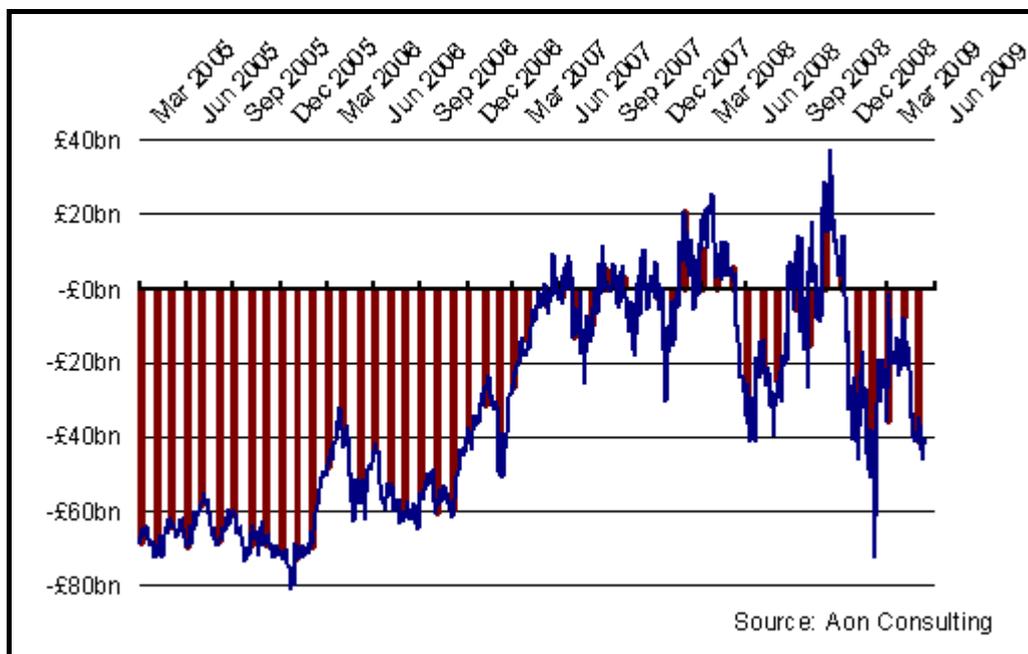
A going concern valuation

The reporting objective should be to reflect fairly the funded status of the scheme, and to produce meaningful information for shareholders as to the likely future long-term cost to the employer of meeting the benefits promised.

The calculation of pension numbers for the accounts of a company necessarily involves a large number of assumptions, some of which stretch into the distant future. The numbers will always be, at best, an estimate, the significance of which is likely to be more distorted than improved by attempts at spurious accuracy in the underlying methodology and assumptions.

In particular, the discounting of all estimated future cash out-flows using a single corporate bond rate with a maturity equal to the expected duration of assets, in arriving at the liability number to be reflected in the employer's accounts, is a case in point. The volatility of both the market value of scheme assets, and AA corporate bond rates in recent years has resulted in the ongoing funded status of schemes under IAS 19 yo-yoing between surplus and deficit (see chart overleaf).

Aon 200 Index: The Aon200 index – a snapshot of 'funding' at the 200 largest UK private sector pension schemes based on current mark to market accounting principles which presents an aggregate surplus or deficit position



A discontinuance valuation

The current IAS19 (and FRS17) approach is appropriate only in the specific event of the company being unable to continue on a going concern basis.



In those circumstances, the Marathon Club agrees that a mark-to-market approach for the valuation of the assets, together with the current long-term risk-free discount rate, would be appropriate to establish the extent to which the scheme was over- or under-funded on the basis that the sponsor's covenant was lost at the balance sheet date.

This measure would arguably enable users of accounts to properly see the extent to which the pension scheme relies on the sponsor's long-term covenant, but the company's own balance sheet should not be prepared on that basis.

If such a disclosure is required in the accounts of a going concern business, the Marathon Club believes that there is a place for accounting under the current standard, modified as set out above, but only by way of a note.

Consistency in valuing assets and liabilities

The idea of marking asset values to market was developed by traders in derivative markets to enable them to measure and settle or collateralise intra-day exposures between one another. This approach has since been increasingly specified by accounting standards boards to value the investments of all holders of financial instruments, however different in orientation.

Accounting standards, including those applying to pension funds, only allow for two types of holder – those holding the asset to maturity, and those whose assets are “available for sale”. By these standards no minority shareholder of equities could possibly be said to be holding them to maturity, however long-term an investor he might be. So accounting standards categorise even long-term investors as if they were day-traders.

We understand that accountants have already recognised that applying a single point-in-time discount rate, based on market conditions at the balance sheet date, is unlikely to produce a reasonable and meaningful result for an ongoing assessment of the liabilities. The use of a single point-in-time value of assets, based on then market prices, is similarly flawed.

Pricing theory

The Efficient Market hypothesis, which underlies the assumption that the current market price is the best estimate of fair value, has been increasingly called into question in recent years. Many commentators have already pointed out the flaws and unintended consequences of rigidly applying the mark-to-market approach across all bank assets for both accounting and regulatory capital requirements. How much more egregious are the same flaws and unintended consequences when forced on the valuation of long-term investments held by pension schemes?

Alternative approach

In the Marathon Club's view, the accounts of a business are intended to show a true and fair view of the company's position as a going concern. For consistency, the funded status of the company's pension scheme should also be measured on an ongoing basis. The Club encourages the accounting profession to look for an alternative approach to making a valuation of pension fund assets and liabilities for the purposes of company reporting, which reflects their long term nature and purpose on a going concern basis. A possible approach for liabilities would be to apply a discount based on a rolling average of corporate bond yields, similar to what is being proposed in Germany. It might also be appropriate, depending on the



maturity and complexity of the fund, to apply different discount rates to different tranches of liabilities.

A dividend or earnings discount model might be a better basis for asset valuation than the blind application of market prices. Of course, there should be a check on the reasonableness of the assessed value compared to current market prices, but no more. Notes to the accounts should explain not only the assumptions used in arriving at asset and liability values, but also the sensitivity of the numbers to changes in assumptions (as is currently required for financial instruments under IFRS7).

Closing remarks

There is a general recognition by the end-users of company accounts that current accounting practice is unhelpful, to the extent that many of them find the cash flow statement the only meaningful part of the accounts.

What seems certain at present is that the current practice of prescribing a valuation approach for pension funds in company accounts on a basis more appropriate to termination is becoming self-fulfilling.

The Marathon Club recognises that changing IAS19 will not be easy. However, if we are to stem the short-termism the current standard creates in the behaviour of end-users, significant change is necessary. The Marathon Club therefore urges the accounting profession to enter into a constructive dialogue with the end-users of company accounts - with pension fund trustees, actuaries and investment professionals - to produce accounting rules which are fit for purpose.

The Marathon Club

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About the Marathon Club

The Marathon Club is comprised of institutional fund trustees, senior executives or senior specialists who have a proven track-record in playing a relevant leadership role in public and private institutional funds and endowments. The members' represent schemes combined assets exceed £170 billion. Yusuf Samad CFA, FSIP is currently Secretary to the Club.

The overall goal of the Club is to stimulate pension funds, endowments and other institutional investors ("Institutional Funds") and their agents to be more long-term in their thinking and actions, and place more emphasis on being responsible and active owners with a view to



increasing knowledge about how their investment strategy and process can improve the long term financial and qualitative buying power of fund beneficiaries.