ICGFM The International Consortium on Governmental Financial Management

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The Technical Director
International Public Sector Accounting Standards Board
International Federation of Accountants
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Dear Sir

1. The International Consortium on Governmental Financial Management (ICGFM) welcomes the opportunity to respond to IPSAS ED59 - 'Amendments to IPSAS 25 – Employee Benefits'.

2. We support the specific changes proposed within ED59 under Comments 1 and 2.

3. However, it is our view that a much more comprehensive revision of IPSAS 25 is required particularly in relation to post-employment benefits. The present IPSAS, even with the amendments proposed in ED59, is not aligned with the issues facing entities in the general government sector (especially sovereign governments) and does not adequately address the requirement for transparency in relation to the inter-generational impact of post-employment benefits.

4. Furthermore, we consider that IPSAS 25 should be restructured to clearly segregate the different types of employee benefits, should in each case move from the general to the particular, and should use language that is meaningful to persons who are not pension experts.

5. We attach a paper setting out the above ideas in more detail.

6. We appreciate the opportunity to comment on this exposure draft and would be pleased to discuss this letter with you at your convenience. If you have questions concerning this letter, please contact Michael Parry at Michael.parry@michaelparry.com or on +44 7525 763381.

Yours faithfully,

Michael Parry

Michael Parry

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ICGFM Ad Hoc Committee on Accounting Standards

Response on ED 59:

Amendments to IPSAS 25

Overview

IPSAS 25 is so complex and the methodology descriptions so abstruse that most accountants will be inclined to regard ED 59 as raising technical issue best left to those with expertise in the pensions area. This is unfortunate, because pension liabilities for government entities[1] are, in many instances, very large in relation to other figures in the balance sheet[2].

Accounting for pension liabilities is very important, but it is our view that by simply replicating most of IAS19 the IPSAS Board is not recognising the special nature of pension liabilities of government entities. In consequence the pension liability disclosure requirements for government entities are inadequate.

Comparison of government sector and private sector pension issues

Pension issues for the commercial corporate sector

Commercial entities' pensions are almost invariably intended to be fully funded. If pensions are based on the returns from pension fund assets (defined contribution), then it follows that there is no risk of any further liability to the entity. However, if the pension is one which defines the benefits without direct reference to contributions (defined benefit pension) then there is the risk that the entity may be liable for pension payments not covered by income from pension fund assets – a pension fund liability.

In the latter situation any shortfall will have to be made good from future revenues of the entity, affecting the future profitability, and possibly the solvency, of the entity. The focus of IAS 19 is on identifying such situations, measuring the potential pension fund liability, profit impact and risk to the entity resulting from the pension liability.

[1] For clarity we use the term "government entities" to describe entities within the General Government Sector and to which IPSAS are applicable. The Corporate Sector refers to commercial entitles, included those owned by government. Using the new IPSAS terminology these latter are referred to as "commercial public sector entities".

2 The UK Whole of Government Accounts 2013/14 estimate the pension liabilities of the UK Government as £1,302 billion (US$1,888 billion) of which 93% is unfunded. This compares to total UK government revenues for the same period of £684.5 billion (US$993 billion)

Pension issues in the government sector

In contrast, pensions schemes of government entities are commonly unfunded (or only part funded) defined benefit schemes. Therefore, many government entities have large unfunded pension liabilities. However, in the case of sovereign governments this liability is offset by the ability to raise taxes or other revenues – a major difference to commercial entities. This and the inter-generational responsibility of governments should affect the disclosure of pension liabilities.

Until IPSAS 25 (or the application by some government of national standards) the potential liabilities from pension schemes were not recognised in government entity financial statements. However, since IPSAS 25 all government entities reporting on the accrual basis are required to disclose their unfunded pension liability.

This has undoubtedly been a step forward in terms of transparency. Where IPSAS 25 has been applied the disclosure of pension liabilities has focused attention on the scale of such potential liabilities[3] to government entities, including sovereign governments.

However, despite the benefits of disclosure, there are arguments for **not** recognising pension liabilities of government sector entities in their financial reports. These arguments against pension liability disclosure are as follows:

- Since governments have legal authority to raise revenues they are in a very different situation to commercial entities which have no such entitlement to future revenues
- Pensions may be paid from such future revenue flows under the control of the entity, and to show a liability without the corresponding asset of such future revenues is misleading
- Since there is no concept of profit in the public sector the impact of pension liabilities on future profit is irrelevant – it is the impact on future generations of citizens that is important.
- Governments do not cease to exist as a result of insolvency – even if a government defaults on its debts the government continues to exist and is still able to pay future pensions.

These arguments require consideration. At the very least they must influence the design of pension disclosure requirements.

However, there are compelling reasons in favour of recognising pension and other post-employment liabilities for government entities:

1. Unfunded pension liabilities of government entities can be very large (see above) and transparency requires that such liabilities be identified and reported
2. Not all entities within the government sector are guaranteed their future existence or have an automatic right to raise revenues, e.g. educational institutions. For such entities the pension liabilities may threaten their very existence. The need to make good any shortfall may impact, for example, on the fees charged to future students.
3. Pension liabilities represent an inter-generational transfer – to the extent that future pensions cannot be met from employee contributions, they must be met from future revenues, pre-empting the use of such revenues for other purposes.
4. Pension liabilities are a factor taken into account in assessments of credit risk, and may affect the cost of borrowing by the entity.

[3] For example, a report on the BBC website on April 16, 2016 on the UK government pension liability emphasised pubic concern with the issue

These arguments are implicitly accepted by IPSAS 25 and are the reasons requiring the disclosure of pension liabilities.

Conclusions on recognising the pension liabilities of entities within the government sector

It is our conclusion that the requirements for transparency require the disclosure of pension and other post-employment liabilities, and particularly the inter-generational impact of such liabilities. Furthermore, that the IPSAS 25 measurement methodology and methodology in IAS19 is appropriate for calculating a single figure value of such liabilities. However, we consider that the presentation and disclosure requirements of IPSAS 25 are inadequate for government entities.

Identifying and measuring the pension liability

IPSAS 25 sets out a general approach for measuring future pension liabilities that is in essence unchanged by ED 59. This requires an actuarial estimate of future pensions that have accrued from contributions made by employees, discounted to their present value. The liability is reduced by the expected returns from any pension fund assets.

In a funded pension scheme the expectation is that the contributions will enable the pension fund to acquire assets that will generate a sufficient cash flow to pay future pensions. However, it is obvious that calculating the level of pension contributions to achieve this outcome involves forecasts of the future that may prove to be inaccurate. This may lead to a shortfall between the pension fund liability to pensioners and the expected revenues from pension fund assets (it may of course also possibly lead to a surplus). The focus of IPSAS 25 is to identify and measure any such funding gap, and then to report this as a single figure pension liability.

The measurement methodology in IPSAS 25/ED 59 is equally valid for commercial or government entities. As indicated above, the difference between commercial and government entitles is that government pensions are often completely, or mainly, unfunded. There may also be other material unfunded post-employment liabilities, for example health care of former employees in the US public sector[4].

Why IPSAS 25 is so complex

There are three reasons why IPSAS 25 is such a complex Standard, as set out below.

1 The mechanics of calculating a single figure for the net pension liability or asset

As indicated above, the mechanics of reducing pension liabilities to a single figure are complex. It requires calculation of the accrued liability for future pension payments (using assumptions for example about life expectancy, survival within an organisation to pension age, interest rates, etc.) and also the anticipated returns from fund assets. It is inevitably difficult to use words to define the calculations.

4 The incidence of government sector pension liabilities in the US is specific to the USA. At the State and Local levels, bonding agencies expect the government to fund 70% of their liabilities. If government does not fund at least 70%, the agency can expect to pay higher interest rates for their municipal bonds. At the federal level, there is no such policy. Health care liabilities are generally unfunded, but are often a substantial cost.

2. The use of terminology in a manner different to normal usage

Terms are used in both IPSAS 25 and ED 59 with a quite different meaning to normal usage. For example, the term "interest cost" does not refer to an interest payment that will ever actually occur or be paid – it is the amount of the notional interest on the defined benefit liability.

3. Confused presentation of the standard

IPSAS 25 is about employee benefits in general. These include short term benefits and defined contribution pension schemes. None of these issues present any major complexities or differences between the government and corporate sector. Yet the requirements relating to such benefits are interspersed with the more complex requirements relating defined contribution pensions.

Even within the part of the IPSAS dealing with defined benefit schemes, the Standard does not follow the principle of moving from the general to the particular. For example, the definition section is immediately followed by a section on schemes with entities under common control, then back to sections on recognition and measurement. This presentation adds to the difficulty of an already complex and long standard.

Proposed changes to IPSAS 25 and ED 59

The basic measurement and valuation principles set out in IPSAS 25, as amended under the proposals in ED 59, are supported as the basis for providing a single figure estimate of unfunded (or part funded) pension liabilities in the government sector. However, this information alone is inadequate, or even misleading, for government entities. A more comprehensive approach is required that:

1. Identifies the unfunded liability for post-employment benefits
2. Identifies and values flows earmarked to meet the cost of such unfunded liabilities
3. Provides an indication of the inter-generational impact of unfunded pension liabilities in future years
4. Makes clear the level of uncertainty in such forecasts and the impact of the more likely variability in the estimates.

These concepts are further expanded below.

1. Amount of any unfunded pension liability

No change is proposed in the calculation methodology set out in IPSAS 25 as amended by ED 59.

2. Funding of pension liabilities

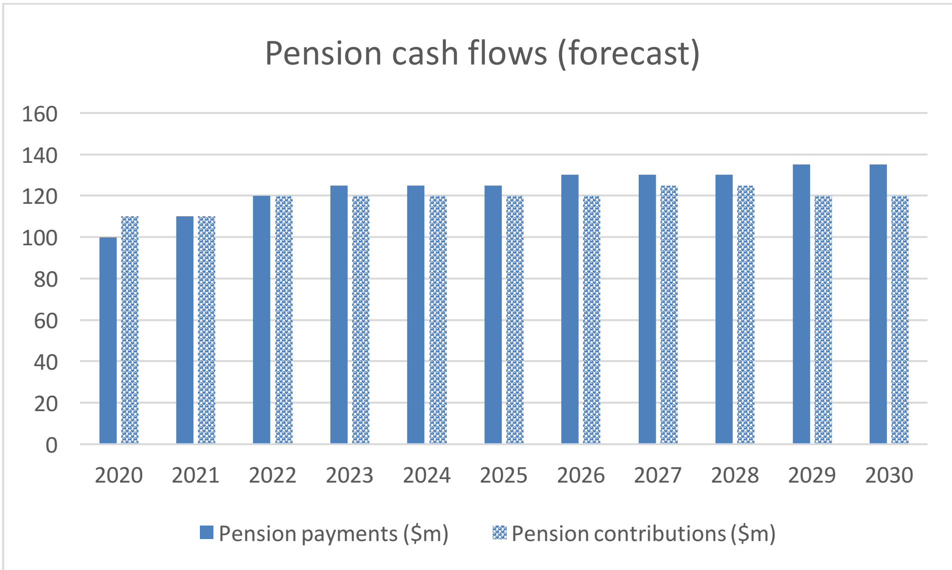
Most government sector entities which have unfunded pension liabilities will (or should) have a plan for funding future pension payments, e.g. future employee and/or employer pension contributions, earmarking of a specific source of revenue, etc. This plan should be described in narrative with a quantification of the anticipated inflows as compared to pension outflows.

Consideration could be given to providing a single figure value of such planned future funding arrangements to be offset against the unfunded pension liability.

3. Future cash flow impact year by year, taking account of any funding plans

Disclosure should involve not just single figure estimates of post-employment benefit liabilities and planned funding flows, but also a year by year estimate of the cash flows. This would clearly indicate the inter-generational impact of employment benefits being incurred by the entity. The information could be presented in a table, possibly also with a graphical representation to make the information clearer as illustrated below.

Figure 1: Example of graphical presentation of pension cash flows over time



4. Assumptions underlying the above calculations, indicating major uncertainties and possible impact of changed assumptions.

Some assumptions underlying the calculation of pension liabilities and future cash flows are subject to particular uncertainty, e.g. life expectancy, interest rates. As well as a central estimate, a range of possible outcomes for both single figure estimates and future cash flows should be provided.

Organisation of the IPSAS

In order to improve clarity a revised structure for the IPSAS is proposed:

- Part 1: short term employee benefits
- Part 2: defined contribution pension schemes
- Part 3: defined benefit pension schemes and other unfunded post-employment benefits

Within each section the Standard should be organised to move from the general to the specific, as indicated below for the proposed Section 3:

1. Basic principles and objectives
2. Calculation of defined benefit pension liability – it might be best to define the main principles and use an annex to provide detailed examples
3. Disclosure requirements

4. Special situations and exceptions.

Pension liabilities of commercial public sector entities

The above analysis relates to entities in the general government sector which are required to comply with IPSAS. Commercial public sector entitles are required to apply IFRS. If the more extensive disclosures described above are applied to government entities, this will raise problems when commercial public sector entities are consolidated into whole of government financial reports. For consolidation purposes the more comprehensive information indicated above will be required from all consolidated commercial public sector entities.

Furthermore, pension liabilities of commercial public sector entities may be a contingent liability of the national government. Even if the pension liabilities of a commercial public sector entity is not expressly guaranteed by central government, it would be a brave government which refused to honour such pension commitments.

First time recognition of pension liabilities

Many, indeed most, governments and government sector entities have not as yet recognised in their financial reports unfunded pension and other post-employment liabilities. IPSAS 25 should provide guidance on first time recognition of such liabilities. In particular, whether the first time charge should be taken directly net equity or a charge against surplus/deficit in the Statement of Financial Performance?

Summary and conclusions

In summary, it is our view that the proposed changes to IPSAS 25 in ED 59 do not go far enough. What is required is a complete redesign of IPSAS 25 so that it requires financial reports to provide information for full transparency on the post-employment benefit liabilities of entities (including sovereign governments) within the general government sector. This information should include information on unfunded liabilities, revenues to meet such liabilities, and forecast future cash inflows and outflows relating to post-employment benefits.