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Amendments to IAS 19

Sir,

With great interest I have studied your discussion paper on “Preliminary Views on Amendments to IAS 19 Employee Benefits (“PV”). I highly appreciate the opportunity to provide you with my comments and suggestions.

Answering the questions presented in the PV would not be an effective way to describe my concerns and therefore I have listed my major comments by chapter.

General

The essence of what is being tried to achieve by IAS 19 and the PV is to determine the requirements how rewards for labor provided, that are not currently settled, but that are to be settled in reporting periods after the period in which the labor has been provided (deferred employment rewards), should be measured and allocated over the period that the labor is provided. I strongly believe that IAS 19 is fundamentally wrong with respect to the reporting requirements for what is (improperly) called post employment benefits. (The notions “post employment” and “completion of employment” refer to periods in which an employment relation does not exist anymore, which ignores that (part of)

deferred rewards may also be paid during employment. “Post employment” or references thereto should thus be abandoned as it introduces an unwanted and unnecessary limitation.)

The central shortcoming of the current IAS 19 with respect to deferred employment rewards is in my opinion twofold. Firstly, it classifies all arrangements in only two categories, thus ignoring that in reality a wide variety of arrangements exists. The dichotomy is based on one, extremely narrow, definition in which the criteria are “fixed contribution” and “no legal or constructive obligation to pay further contributions”. If an arrangement does not meet this definition, no matter how close it comes to meeting it, it is classified as other, in IAS 19 described as “defined benefit”. An arrangement might thus be classified as “defined benefit”, while in reality the arrangement might not define a benefit at all or might define a limit for paying further contributions. Also, the definition only focuses on “no ... obligation to pay further contributions”, but does not address situations where the accumulated contribution might include a surplus. Secondly, for the other group of arrangements (“defined benefits”) only one measurement method is prescribed, to be applied whether or not it fits the actual arrangement: the PUC method. While the PUC method might be an adequate method to measure an arrangement, whereby an entity is liable without limit for settling a deferred employment reward, it falls short of providing the correct measure if any limit to the entity’s obligation is arranged for.

Paragraph 2.4 also gives a good description of some of the issues, that are wrong with the current IAS 19, namely that it “ treats changes in defined benefit obligations and in plan assets differently from changes in other assets and liabilities ”...” in order to accommodate views”. Or, put more straightforward: IAS 19 without the “corridor” produced results, which were inconvenient, i.e. volatile and instead of investigating whether these “volatile” results are a result of errors in IAS 19 or indeed portraying reality, the “corridor” was introduced with an arbitrary 10 percent threshold and optional application. In my view this is a perfect example of an erroneous standard, caused by standard setters not being guided by a complete, coherent and comprehensive Conceptual Framework.

In my opinion there is no need to make any classification in the wide variety of arrangements existing in reality, nor does any rationale exist to prescribe only one method of measurement. Instead, the broad principles for measurement of the obligation with respect to deferred employment rewards could be as follows:

1. In accordance with the reward formula.
2. If requirements are met to apply statistics at all, than life expectancy statistics as well as probabilities with respect to the deferred rewards becoming vested (e.g. age, number of employment years, salary level) should be applied.
3. Discounting the obligation should take place if:
 - Resources are identified to fund the obligation, and
 - These resources are probable to earn the discount rate to be applied and

- These resources and the return on those resources will flow to those who are entitled to the deferred reward (hence, these resources are not assets of the reporting entity).

Allocation of the deferred rewards should be pro rata the value of the labor provided during employment (probably the best measure of the value of the labor provided in a year is the reward settled in that year).

Chapter 1

In § 1.5 you acknowledge that major flaws exist in the current IAS 19. In order to deliver improvements an investigation into the causes for these flaws as well as the appropriate measures to remove those causes would ensure, that the improvements could indeed be delivered. In other words: how can it be achieved, that by removing the current flaws no new ones are introduced? In my opinion the cause of these flaws is that the current Conceptual Framework is incomplete and inconsistent and I would suggest that the Board gives highest priority to finalizing it into a coherent, comprehensive and concise Conceptual Framework. In § 1.6 you refer to “decision-usefulness of financial reporting”. In my opinion financial reporting is about portraying reality and whether that reality provides useful information is up to the user to determine, not something the IASB can or should determine.

Chapter 2

I share the Board’s views expressed in § 2.2 first and second bullets: it is logical and consistent with treatment of other types of assets and liabilities. The view contained in the third bullet I would only agree with, if the plan amendment vests, or probably vests, the previously unvested past service cost.

In § 2.8 the Board reaches conclusions which I fully support and which should be included in the CF forthwith:

First bullet: “... difficulty in measuring the liability or potential imprecision does not provide sufficient reason not to measure it.”

Second bullet: “... the possibilities of future offset do not justify non-recognition of (actuarial) gains or loss” (note: brackets added by me, because the statement is true in all cases)

Third bullet: “A measure should be volatile if it represents faithfully transactions and other events that are themselves volatile”

Fourth bullet: “The role of accounting is to report transactions and events in a neutral manner.”

I urge the Board to consider whether the objective of financial statements, which includes "... that is useful to a wide range of users" is in conflict with "a neutral manner". In my opinion it is. If neutral information does not provide information useful to a wide range of users, would than neutrality be sacrificed? If yes, I dare not think of the consequences. If no, the criterion "that is useful to a wide range of users" can be taken out because there is a higher order criterion, i.e. "neutral manner"

Paragraphs 2.10, 2.11 and 2.12: I fully agree.

In § 2.15 the Board concludes that the return on assets should not be divided into an expected return and an actuarial gain or loss, because it provides "... an opportunity ... to manipulating". I agree with the Board's conclusion that return on assets should be presented as one amount. However, its reasoning I do not subscribe to. Would the Board abandon neutrality if the manner of accounting provides opportunity for manipulation? I don't think so. The real argument is not potential manipulation, but correcting the flaw in IAS 19, that led to dividing the return on assets.

I agree with the Board's view expressed in § 2.21 that "entities should recognize all effects of changes arising from plan amendments in the period in which the plan amendments took effect", assuming that it should be interpreted as: "... in which the change took effect".

Chapter 3

I fully agree with approach 1. All changes in value of all assets and all liabilities should be presented in an all inclusive statement of profit and loss. There exists no reason whatsoever to exclude any change in value of any sort of asset and liability from profit and loss. "Volatility", "beyond management control" (§ 3.5), "different predictive value" (§ 3.6) are arguments expressing disregard for neutrality and lead to presenting something else than real outcomes.

Paragraph 3.18 describes that some believe that a criterion for presenting items in a profit and loss statement is that these should have the same predictive value. Apart from determining which profit and loss items have similar predictive value being in my opinion highly arbitrary, how would items with different predictive value be presented? In the same profit and loss statement? Or in two different ones, or even more? The example in § 3.18 exactly demonstrates the problems inherent to the "predictive value" criterion for inclusion of items in profit and loss. The management of the entity has decided to acquire assets, i.e. raw materials, thus consciously exposing the entity to fluctuations in the raw material prices. It has also hired personnel at conditions requiring the entity to carry assets, thus consciously exposing the entity to fluctuations in prices of these assets as well. Any result from any price fluctuation in assets is a direct consequence of management's decision to carry those assets and no reason exists to treat results from price fluctuations differently for different assets.

I agree with the Board's observations on curtailment and settlement expresses in § 3.33 and § 3.34.

Chapter 5

The key of the PV is in my opinion in § 5.3. The Board has the view that definitions are to be changed into:

“Post employment benefit promises are formal or informal arrangements under which an entity is obliged to provide employee benefits (other than termination benefits) payable after the completion of employment”

The definition might present problems in its application, as it raises a lot of questions:

- “Promises are ...arrangements” Why “arrangements”? How about promises that do not qualify as arrangements”?
- “Formal or informal” Is this the same as legal and the same as constructive obligation or not? And is promise something different than constructive obligation?
- “Promise...payable after completion” Is full completion meant and partial completion excluded (I can give you an example of an arrangement whereby part – time retirement is an option)? Is completion of employment meant to express the same as post-employment? And how about deferred rewards, which are settled during employment?

Next the Board proposes in its PV a new definition of a defined benefit promise. This definition of a defined benefit promise is (unfortunately again) basically: anything that doesn't meet the definition of a contribution based promise is a defined benefit promise. No rationale is offered for this dichotomy. I believe that such approach is not a proper one: reality cannot be captured in a dichotomy and it should always be tried to come up with a positive description of something.

In § 5.6 promise 1 is described, whereby the Board using its definitions concludes in § 5.7 that the two features of the promise should be treated differently. Both features define that the obligation of the entity at any point in time up to post-employment date is a lump sum representing the accumulated contribution. The contribution is based on a defined formula, whereby in the second feature (next 15 years) an estimate with respect to future salary need be made. Definitely not a reason for a different treatment!

In § 5.14 three phases are distinguished. It is not made clear whether these phases are meant as being sequential or not. For certain the three phases will in reality be sometimes parallel phases, as deferral starts virtually at the same moment as accumulation and the payout phase might start during accumulation. The distinction is not very useful and will in its application undoubtedly lead to different interpretations

In § 5.38 thru § 5.43 the weakness of the proposed definitions are in my opinion clearly exposed. A line is drawn at “final three years” or (§ 5.40) “the average of the employee’s salary in the final years of service”. What is the line exactly? Three years? Three and a half? Five? And if there is a line, what is the rationale for it? I doubt whether there is one.

In § 5.40 the concept of the salary risk is introduced. The concept holds that if a post employment benefit depends on a future salary than it should be accounted for differently than if the benefit does not depend on a future salary. Does the concept of future salary also include next year’s salary, which in most cases can be estimated highly accurately? And why should these “next year salary” types of promises is treated differently? A reference to future salaries only means that estimates need be made. Again: the fact that, an estimate need be made can never be a reason for a different accounting treatment!

I disagree with the position taken by the Board in § 5.52 (and § 6.3), that unvested promises should be treated in the same way as vested promises. Promises are unvested because such is very probable an intended result of the agreement between employer and employee. Disregarding this fact means that the financial report does not portray reality, not the real facts. I very much doubt that the presented position of benefits being vested, while these are in actual fact not vested, would be “useful information to wide group of users”. Unvested promises should only be treated as vested if vesting is probable.

Chapter 7

I agree with the conclusion of the Board in § 7.6, although its reasoning is weak: it uses an example in § 7.5 and the argument of “accounting arbitrage”. A proper CF would have provided the basis for the answer to the question of the unit of measurement. And “accounting arbitrage” should never be a reason for determining a certain reporting standard. Only one, all overriding, argument exists: the reporting method leads to the best representation of reality. In the case of labor, management of an entity might have agreed with (an) employee (s) to defer part of the reward to later phases, possibly including the post employment phase. Hence the disaggregation should be no more than current rewards and deferred rewards.

I do not agree with the position taken in § 7.19, that all liabilities, due more than twelve months after reporting date, should be discounted. See my reasoning above.

Chapter 8

I do not agree with the Board’s view (§ 8.2 and § 8.11), that measurement should be in the same way in the payment phase and the deferment phase as in the accumulation phase. As the Board noted itself “the same obligation should be accounted for in the same way” (§ 8.8). It cannot be that the same obligation can be represented by two (or more) different amounts. Let not the consistency argument override the “faithful representation” objective.

The contradiction noted by the Board in § 8.8 is not about “two beliefs” that are incompatible, but are yet another demonstration of the erroneous approach taken in IAS 19 and the PV with respect to reporting requirements for deferred employment rewards and a demonstration of the failure of the dichotomy and the underlying definitions for contribution based and benefit based rewards.

Chapter 9

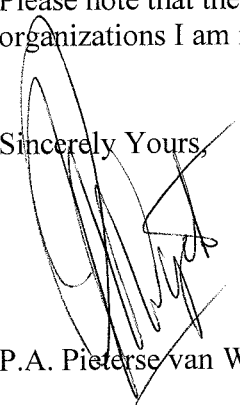
Both contribution based and benefit based rewards are deferred employment rewards; both are rewards for labour currently provided. No matter how complicated the reward description might be and no matter how different any two reward descriptions might be, no reason exists for a different treatment with respect to disaggregation and presentation.

Conclusion

My comments are aimed at demonstrating to the Board that IAS 19 has major flaws and that the PV do not correct those flaws, but rather aggravate them. I urge the Board not to introduce the PV into IAS 19, but instead devote its resources to a complete overhaul of IAS 19, possibly along the lines I have suggested.

Please note that the above views are my personal views, not the views of any of the organizations I am related to.

Sincerely Yours,



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