AMERICAN ACADEMY *of* ACTUARIES

September 26, 2008

International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

Re: Discussion Paper: Preliminary Views on Amendments to IAS 19 Employee Benefits

Dear Sir or Madam:

The American Academy of Actuaries'[1] Committee on Pension Accounting thanks the IASB for this opportunity to comment on its *Discussion Paper: Preliminary Views on Amendments to IAS 19 Employee Benefits*.

We commend the Board for its well-conceived effort to improve employee benefit accounting and comparability in a limited-scope project. We do have reservations, however, and we limit our comments below to those areas of the discussion paper that are most problematic from a U.S. perspective. In general, we do not comment on final-pay defined benefit or retiree medical plans, as being outside the scope of the discussion paper, although we have serious concerns about measurement in those areas as well.

Our principal reservations are that 1) "contribution-based promises" are defined to encompass too many plan designs, and 2) the proposed valuation method would lead to less, rather than greater, comparability among the financial statements of different preparers. Our detailed comments below follow the questions set forth in the discussion paper.

Question 1
Given the objective of the IASB project to address specific issues in a limited time frame, are there additional issues which you think should be addressed by the Board as part of this project? If so, why do you regard these issues as a matter of priority?

The discussion paper already goes well beyond the bounds of a "limited-scope" project, and any new issues should only be added as part of a comprehensive review of all pension accounting issues. In particular, the definition of a "contribution-based promise" has been expanded beyond the usual understanding of that term and would apply to common U.S. designs (career-pay, flat dollar and frozen plans) that are not among the "troublesome" plans that motivated this limited-scope project.

The proposed definition of contribution-based promise would affect a great many, probably a majority, of U.S. single-employer defined benefit plans, thereby creating disparate accounting treatment of identical annuity portfolios depending on whether they arose from a defined benefit or a contribution-based promise. We believe this distinction runs counter to the IASB's objective of improving comparability in pension accounting.

Question 3

a) **Which approach to the presentation of changes in defined benefit costs provides the most useful information to users of financial statements? Why?**

[1] The American Academy of Actuaries is a professional association with over 16,000 members, whose mission is to assist public policymakers by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

b) In assessing the usefulness of information to users, what importance do you attach to each of the following factors, and why:
- **(i) presentation of some components of defined benefit cost in other comprehensive income; and**
- **(ii) disaggregation of information about fair value?**

c) What would be the difficulties in applying each of the presentation approaches?

We agree with the conclusion of Chapter 2—*Deferred recognition of changes in the liability for defined benefit promises* that the fair value of assets and obligations should be recognized in the balance sheet, and that changes in fair value be recognized in comprehensive income.

With respect to Chapter 3, *Presentation approaches for defined benefit promises*, we think that the outcome of the financial statement presentation project is critical to determining the appropriate presentation of changes in asset and liability values in comprehensive income. Until the financial statement presentation project is sufficiently advanced to provide clearer guidance, we think it is inappropriate to address the various cost-recognition approaches. For example, components of benefit cost that are in the nature of investment income and financing costs should not casually be characterized as being part of operating income.

We also agree that treating the promise, and not the plan, as the unit of account makes sense, as it would allow the funded and non-funded portions of a single promise to be measured and recognized as a single unit. For example, in the U.S., a common design provides a certain level of benefits, but due to tax limitations on the amount of benefits that can be prefunded, the benefits for highly paid or executive employees are provided partially by a funded plan and partially from general corporate assets. Currently, these arrangements are treated as separate plans.

If we understand the discussion paper correctly, *all* of the benefit promises to an employee would be recognized as if they were part of a single promise. However, the reverse situation poses difficult issues. Many plans consist of a group of promises, all supported by a single pool of assets. This is well understood in the context of multi-employer plans (where each employer has made a promise) but is also the case where a plan of one employer covers several employee groups, each of which has a different benefit formula. To account for each promise separately, one would need to allocate assets among the benefit promises, and it is not at all clear how such an allocation should be performed.

If the Board does apply the methodology of the discussion paper to the income statement, we have the following specific comments:

The phrase “changes in service costs caused by changes in the assumptions other than the discount rate” in paragraph 3.13 should be clarified. We understand that by “service costs,” the IASB intended to refer to “the present value of the defined benefit obligation (DBO).” If that is indeed the case, of the three approaches to income statement presentation posed in Chapter 3, we prefer the variant of Approach 2 set out in paragraph 3.14, namely, that service cost alone should be presented as operating cost in profit and loss (P&L). This approach has the merit of simplicity and avoids having to allocate gains and losses on the DBO between changes in the discount rate and other changes. It is also essential in projecting the ongoing operational costs of the business entity—a key requirement for the users of financial statements. If the P&L instead reflects the effect of some changes in the DBO as well as service cost, it would be necessary to disclose the service cost separately in order to project results.

Question 5
Do you agree that the Board has identified the appropriate promises to be addressed in the scope of this project? If not, which promises should be included or excluded from the scope of the project, and why?

We do not think that the discussion paper appropriately identifies the "troublesome" promises that urgently needed "fixing"—benefit promises with a 'higher-of' option and benefit promises that depend on the actual return of a basket of assets. Benefit promises based on a fixed rate of return, a stipulated *yield* on bonds rather than the total rate of return on those bonds, or the value of a non-asset-backed index (such as an index of inflation) are distinguishable from promises based on the performance of assets actually available in the marketplace. It is promises of the latter type that create problems because similar promises, outside of the pension field, are accounted for differently from the same promises within a pension plan. The discussion paper defines a contribution-based promise in a manner that affects "non-troublesome" plans and raises significant measurement issues that properly should be addressed only in a comprehensive review of measurement issues for all postretirement benefit promises.

In particular, defining a contribution-based promise to effectively include any plan that pays benefits not based on final salary is arbitrary and creates enormous consistency problems. For example, many U.S. plans have multiple formulas some of which are based on future salaries and some of which are not.

As the Board notes, treatment of annuities would vary depending on whether they arose from a defined benefit promise or from a contribution-based promise. The Board might consider an alternative whereby the election by a participant of an annuity from a contribution-based promise would cause that promise to thereafter be accounted for as a defined benefit promise.

Under the discussion paper, a plan with a career-pay formula could be treated differently from a plan with a final-pay formula based on the same years of service, even if both plans provided the same benefits. We also note that the definition is rule-based, rather than principle-based, and thus would appear to be in violation of IASB's conceptual framework.

In summary, "contribution-based promises" should include *only* those promises that are expressly linked to the actual return on specific assets, and for which the employer has no further obligation, risk, or reward related to the performance of those assets.

Question 6
Would many promises be reclassified from defined benefit to contribution-based under the Board's proposals? What are the practical difficulties, if any, facing entities affected by these proposals?

Many U.S. plans, perhaps a majority, would be reclassified under the discussion paper. Cash balance plans would certainly be reclassified, as would also a number of plan designs that are clearly not contribution-based under any common understanding of the term. These include standard hourly plans (a flat dollar amount per year of service, with the dollar multiplier increasing usually as a result of collective bargaining) and career-pay plans, whether revalued or not. For these plans, the accrued benefit is defined as a pension, not as a lump sum. These plans are much closer in practice to final-pay plans than to true defined contribution plans. Note for example, that a career-pay plan with a cap on service is indistinguishable from a final-pay plan, and a final-pay plan with a long salary averaging period is indistinguishable from a career-pay plan.

Because the discussion paper would change the measurement and recognition of contribution-based promises, reporting entities' results might not be comparable to the results of other plans sponsored by the entities, nor with the financial statements of other entities. As noted above, one plan can include the two types of benefit (but not be a 'higher-of' plan) and it is not clear what principles would guide the valuation of such liabilities.

In addition, the change in measurement attribute for contribution-based promises, as defined in the discussion paper, will result in many reporting entities replacing the well-known, relatively objective, comparable and standardized measurement methods of IAS 19 with new, untested measures based on assumptions over which management would have a much greater degree of control. Expanding the potential diversity of practice does not appear to be consistent with the Board's goal of improving accounting or comparability.

We also note that introducing a third benefit type—contribution-based promises—does not promote clarity. It replaces one gray area, the distinction between defined benefit and defined contribution plans, with two, the distinctions between defined benefit and contribution-based promises, and between contribution-based promises and defined contribution plans.

Question 7
Do the proposals achieve that goal [of not changing significantly the accounting for true defined contribution plans]? If not, why not?

To properly meet this goal, true defined contribution plans would need to be clearly excluded from the definition of a post-employment benefit promise. For example, the proposal could clarify that a true defined contribution plan is not a promise of future post-employment benefits, but a form of current earned compensation in which assets are set aside, invested, and the results reported to the participants.

Question 9
a) **Are there alternative measurement approaches that better meet the measurement objectives described in this paper? Please describe the approaches and explain how they better meet the measurement objectives.**
b) **To what extent should the effect of risk be included as a component of the measurement approach at this stage of the Board's post-employment benefit promise project? How should this be done?**

The discussion paper defines fair value as "the amount for which an asset could be exchanged, or a liability settled between knowledgeable, willing parties in an arm's length transaction."

It is not clear how this definition would apply to the measurement of contribution-based promises because the market is quite thin.

The discussion paper's definition of fair value would be yet more problematic if extended to defined benefit promises and retiree medical plans. A willing promissor can only transfer such a promise by (a) paying out the value as a lump sum to the participant, (b) transferring the obligation to an insurer, or (c) in rare instances, transferring the obligation to a third party other than an insurer. While longevity and investment return are traditional insurable risks with established pricing mechanisms, many other risks borne by the promissor are not. These include the risks associated with optional retirement or termination age, future salary increases, future costs for medical services and future benefit indexing. It should be noted that these risks are often subject to control of the promissor or the insured and, accordingly, are by their nature, uninsurable.

The insurance market today is essentially limited to fixed benefits (or benefits indexed to the performance of a specific package of securities) for those who have completed the accumulation phase. As long as it remains impossible to transfer most benefit obligations in the market, fair value will inevitably be a highly speculative process. We recognize that those same challenges apply under IAS 19 as presently constituted, but there is no pretense that the current reporting is on a fair value basis.

Guidance is also needed on taking risk in general, and credit risk in particular, into account. For example, does the credit risk reflect the creditworthiness of the sponsor of the plan or of the parent company? What about joint ventures? Should a risk-free rate be disclosed as well in the interest of intercompany comparability?

Question 10
a) **Do you agree that the liability for benefits in the payout and deferment phases should be measured in the same way as they are in the accumulation phase? If not, why?**

b) What are the practical difficulties, if any, of measuring the liability for a contribution-based promise during the payout phrase at fair value assuming the terms of the benefit promise do not change?

We do *not* agree that it is appropriate to value benefits in payment in the same way as benefits in the accumulation phase. For example, in the accumulation phase, there may be a guaranteed interest rate on the contribution account and an option at retirement to select a lump sum or a pension must be reflected with certain probabilities. If the employee selects a pension at retirement, the risks are replaced by a mortality and discount-rate risk.

We believe that all annuities should be valued the same way—as part of a defined benefit promise— regardless of how they were created during the accumulation phase. Any difference between the present value (or cost) of the annuity at the time of retirement and the accumulated notional contributions or the previously expensed benefit obligation is properly an ordinary gain or loss, reflecting a refinement of estimate as new facts become available. The decision of an employee to retire or commence benefits is essentially a transaction, and the gain or loss created by that transaction should be recognized in the liability at that time.

Question 11

a) What level of disaggregation of information about changes in the liability for contribution-based promises is useful to users of financial statements? Why?

b) Do you agree that it is difficult to disaggregate changes in the contribution-based promise liability into components similar to those required for defined benefit promises? If not, why not?

It is very important for the users of financial statements to see the same level of disaggregated information as is currently considered useful for defined benefit plans. Investment analysts need to be able to distinguish between the different cost components based on their nature or cause. Specifically, cost components that represent deferred wages (such as service cost) need to be readily distinguished from cost components that result from market fluctuations (such as discount rate changes and investment changes).

Question 12

Should changes in the liability for contribution-based promises:

a) be presented in profit or loss, along with all changes in the value of any plan assets; or

b) mirror the presentation of changes in the liability for defined benefit promises (see Chapter 3).

Why?

Changes in the liability for contribution-based promises should be reported consistently with the reporting of changes in the liability for defined benefit promises. However, our response should not be construed as saying that we support Approach 1.

Question 13

a) What are the practical difficulties, if any, in identifying and measuring the 'higher-of' option that an entity recognizes separately from a host defined benefit promise?

b) Do you have any other comments on the proposals for benefit promises with a 'higher-of' option? If so, what are they?

The discussion paper proposes that 'higher-of' promises be valued by assuming a host defined benefit plan with a contribution-based promise on top. It is not clear how this would work in practice. In many cases, it would be much easier and more intuitive to value the contribution-based promise as the host, with the defined benefit on top. Our view is that facts and circumstances should dictate the approach.

For example, many U.S. cash balance plans have active participants with grandfathered or guaranteed defined benefit promises. Sometimes these grandfathered promises grow and sometimes they are frozen. However, all current active participants typically accrue benefits under the cash balance formula. For such a plan, it is easier and more intuitive to value all participants under the contribution-based promise, and then value the defined benefit promise (for the subset of employees entitled to the defined benefit promise) on top. Conversely, in a final-pay plan with an old frozen cash balance account serving as a minimum benefit, it is more intuitive to assume the defined benefit plan was the host plan and then value the contribution-based promise on top.

In short, we think the approach used when a higher-of option exists should vary based upon the nature of the promise. In the case where there are two competing formulas for all employees, we believe the host plan should be the one that is expected to prevail most of the time. Where there is one plan covering distinct employee groups, with the groups accruing benefits under different types of promises, we believe that segregating the population and valuing each based on the nature of their individual promise is appropriate.

On the other hand, if contribution-based promises are not segregated from other defined benefit plans and then measured differently, it would be possible to analyze higher-of plans based solely on the defined benefits provided to participants.

We appreciate the opportunity to offer these comments as the IASB reviews its standard of accounting for pensions. If you have any questions or would like to discuss the contents of this letter, please contact Jessica Thomas, the Academy's pension policy analyst at 202-223-8196, Thomas@actuary.org.

Sincerely,

William J. Sohn, MAAA, EA, FCA, FSA
Chairperson, Committee on Pension Accounting
American Academy of Actuaries

Copy: Frank Todisco, Senior Pension Fellow, American Academy of Actuaries
James F. Verlautz, Pension Committee Chairperson, American Academy of Actuaries
Committee on Pension Accounting