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Sir David Tweedie
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Dear David

IASB Discussion Paper Preliminary Views on Amendments to IAS 19 ‘Employee Benefits’

First, let me congratulate the IASB use of the webcast as a dissemination tool for the discussion paper. I could not put it better than the author of “The Latest from European Pension //iorp.eu” blog has put it on 3 April 2008. Here is what he had to say: “I think that the IASB ought to add public webcasts to its ongoing projects due process. The ease of (global) participation and dialogue would enhance the reach of the IASB's due process to a new group of users (of financial statements) which was hitherto unreachable due to lack of time and attention.” Indeed, I would not (and could not) have had the chances to hear about these proposed changes otherwise, at least not in an efficient and inviting way.

Let me start with a quick note on my background. I have been practicing actuarial and investment consulting for pension funds in the UK over the last 6 years and have been involved heavily, one way or another, with the IAS 19 standard. I would not pretend to be an expert and understand the absolute details of it. I must also qualify that I have not read the full discussion paper. My views will therefore be high level and restricted to the areas I am most familiar with.

SCOPE OF THE DISCUSSION PAPER

To the extent of my knowledge and familiarity with the matter, my opinion is that the scope of your review is broadly right, in the sense that I can’t think of any other issues to add to your list, other than the issue of the valuation basis, namely the discount rate. I genuinely believe this should be sorted once and for all. This review provides a great opportunity to do so, and missing it would push the discount rate issue to the end of the next decade, which looks a world away!

CURRENT FUNDED STATUS and CORRIDOR METHOD OPTION
In a similar spirit to Einstein and Occam's Razor principles I believe the simpler solution should always prevail, provided it is a good enough solution. Providing choices renders the accounting reports less transparent - making them less comparable at face value and therefore less useful. In other words, as a general principle I am against giving too many options in the guidance necessary to prepare accounting reports. There are already enough "opportunities" to make judgments and come to different conclusions. To make my point clear let's use a simple example – under IAS 19 the liability discount rate can easily vary by up to 0.25% just because different parties use a different rounding methodology. Such a range applied to typical liabilities could mean as much as a 5% difference in reporting the value of an otherwise equivalent set of liability cashflow.

My understanding of accounting reports is that they should try to reflect the economic reality of an entity as accurately as possible at any given point time. To put it naively it's taking a picture of the current state of health of a corporation's finances. The smoothing of some accounts appears misleading. It also feels like an anachronism in today's world when what I hear are demands for more fair value reporting in general and more transparency. The corridor method (i.e. the disclosure of a "smoothed" funded status and reporting of the discrepancy with the true position in a note) is akin to a photographer editing his pictures and listing edits at the back of it. It makes the pictures much less useful and relevant, if at all, and potentially misleading. It forces the user in search of truth to alter the picture back to its original version using the notes – which looks to be a considerable waste of time. And contrary to the Paris Hilton pictures amateur, I think financial analysts are looking for the true nature of the object being photographed (i.e. the financial health of a company). Let me emphasize my point by noting the first thing I learned whilst studying to obtain my CFA charter. It taught us to add back the unrecognized gains/losses to the funded status (of disclosed pension liabilities in the account) to get a true picture of an entity's funding position!

In conclusion, I am FOR the full recognition of the current funded status in the balance sheet directly as is stands. I am AGAINST the use of the corridor method option because 1) it is offering unnecessary choice and 2) it is in fact a bad option in itself.

RECOGNITION OF CHANGE IN FUNDED STATUS
I have had less exposure with the income statement and therefore I have a lighter understanding of the issues at play in this section. I understand that if the current funded status is fully and immediately disclosed then there is a need to put the change in funded status (stemming from the service cost, interest cost and various gains/losses) through either the income statement or the (Statement of Recognized Operating Income and Expense account or SORIE under IAS 19). My understanding is that both of these items will have the same numerical impact on the shareholder's equity. The issue must therefore come down to the question of the purpose and definition of the income statement. Making all items flow through the income statement will force entities to be closer to the management of their pension funds, which appear like a desirable outcome.

Clearly the interest costs and return on assets are financing issues and should be reported as such in the income statement. The accruing of benefits is an operation expense. This leaves only the actuarial gains and losses. In this case it is more difficult because management has much less control and insight on the actuarial assumptions, especially the demographics. They can, to some extent, manage turnover and retirement flow, but have much less impact on mortality for example. However, for simplicity it appears that using the income statement for all items of the pension expense would be more straight forward, rendering the financial reports more comparable and useful to their users. Therefore it feels reasonable to “pass” the actuarial gains/losses through the operating incomes.

Theses changes will create added volatility to the income statement, and, similarly to the recognition of the funded status on the balance sheet, will make defined benefit funds less popular in the financial and managerial communities. In my opinion, this should not be considered in deciding on the best approach to adopt. To refer back to the photographer’s analogy, I believe it is not the photographer’s role to edit its photos to make the reality more “acceptable” than it is. If this is to be the final nail in the coffin of defined benefit pensions, so be it. There might be a good reason for it. It may be that DB schemes are not appropriate in the current competitive and ever challenging global economy. Maybe they should be replaced by another system that works better for everyone. However, I shall note that this is a much wider issue than the IASB discussion paper and should be left to be debated by the relevant society’s stakeholders – while transparent and accurate intelligence is provided by the accounting community.

EROA

The fact that companies book expected return in advance, again, looks like an anachronism to me. To this day I don’t understand why this is the case. The more transparent and simple way to deal with this is to book actual return on assets as they are earned at the end of the year. If numbers are not readily available an estimate of the actual return on assets should nonetheless be available. Having calculated such numbers myself I know an appropriate and reflective estimate is available in time. It would seem reasonable to book the actual return on assets as it is earned directly through the financing item of the income statement. A reasoning to back this approach is to <u>assume</u> that plans “should” be fully funded (on “a” basis anyway – true this may be arbitrary however). If this were the case it would be possible to invest in such a way so that the assets generate approximately the same return by which the liabilities grow (I note that this is not a simple task and requires the help of the investment advisers and the will of the Trustees, but is nonetheless achievable). Therefore, rendering the financing cost fairly stable across time removing the need to smooth actual returns or hide them. However, if companies (or Trustees) choose to invest in more volatile equities (in the hope of lowering future pension costs for example) this is an informed choice that they are making and they should be prepared to bare the consequences of their choice (by way of more volatile financing items). This argument is similar to saying that equity investments are not a free lunch. The current climate could lead (and I have seen that personally during my short career) company managers investing in equities in order to boost their earnings. Worst again, I have witnessed a situation where a sponsor did not want to change the investment strategy away from equities because it had already “booked” the expected return in its earnings forecast and doing so would jeopardise their chance of delivering according to the original plan. This is a great example of the law of unintended consequences!

In conclusion to this section I would favor recognizing all items of the pension expense in the income statement. The only exception “could” be the actuarial gains/losses due to demographic assumptions (which are outside the control of the management and for which there are not – yet – efficient hedges). One thing is sure - I would make EROA a thing of the past.

I hope my comments can provide useful insights to this debate.

Thanks and regards,

Antoni Forgues