Hewitt Associates Limited
6 More London Place
London SE1 2DA
Tel +44 (0) 20 7939 4000 Fax +44 (0) 20 7939 4411
www.hewitt.com/uk

Hewitt

DRAFT

IASB Discussion Paper
Date: 26 September 2008
Prepared for: IASB
Prepared by: Hewitt Associates Limited

Comments on Discussion Paper "Preliminary Views on Amendments to IAS 19 Employee Benefits"

Introduction

This paper is submitted on behalf of Hewitt Associates. We appreciate the opportunity to comment on the IASB Discussion Paper "Preliminary Views on Amendments to IAS 19 Employee Benefits".

About Hewitt Associates

For more than 65 years, Hewitt Associates (NYSE: HEW) has provided clients with best-in-class human resources consulting and outsourcing services. Hewitt consults with more than 3,000 large and mid-size companies around the globe to develop and implement HR business strategies covering retirement, financial and health management; compensation and total rewards; and performance, talent and change management. As a market leader in benefits administration, Hewitt delivers health care and retirement programmes to millions of participants and pensioners, on behalf of more than 300 organisations worldwide. In addition, more than 30 clients rely on Hewitt to provide a broader range of human resources business process outsourcing services to nearly a million client employees. Located in 33 countries, Hewitt employs approximately 23,000 associates. For more information, please visit www.hewitt.com.

Key points

Our detailed responses to the questions raised by the IASB are set out in the Appendix to this letter. Our key points are summarised below.

- We agree that:
  - it is difficult to justify deferred recognition of gains and losses, and acknowledge that the balance sheet items that result from deferred recognition are both complicated and potentially confusing
  - it is difficult to justify inclusion in P&L of the expected return on assets as currently derived, but suggest retaining the subdivision of the actual return into a notional expected investment return (included in P&L) and an actuarial gain or loss. This notional expected return could, for example, be calculated by applying the discount rate used to measure liabilities to the asset value, giving an amount that is consistent with the interest cost on liabilities and avoiding the subjectivity that is of concern with the current definition.
- We can see no pressing reason to address the presentation of the change in defined benefit liabilities. In our view, this is an issue that should not be addressed before the completion of the current comprehensive project on financial statement presentation, and this issue should therefore be removed from the scope of the current project.

DRAFT

- We acknowledge that the current accounting for defined contribution and defined benefit plans is inconsistent and that certain benefit designs do not fit very well into the current definitions. However, we do not believe that any issues in relation to the definition of defined contribution promises or in relation to promises that would be categorised under the proposals in the Discussion Paper as contribution-based promises require the Board's immediate attention. Since the proposals in the paper are themselves problematic – far more so than the current requirements as we explain in our detailed comments – in our view, these issues should not be considered in this project. Instead, they should be addressed as part of the planned Phase 2 project considering a comprehensive review of pension accounting.
- Similarly, due to the magnitude of the extra costs that would in practice result from implementing the proposals for "higher of" promises – as explained in our detailed comments - in our view this issue also should be deferred and considered as part of the planned Phase 2 project considering a comprehensive review of pensions accounting.
- In our view, this comprehensive review of pension accounting should itself be deferred until the various issues considered in relation to the proposals for contribution-based promises (fair value, allowance for credit risk, allowance for other risk both diversifiable and non-diversifiable, marking to market, recognition of gains and losses, presentation of financial performance) have all been addressed in comprehensive projects at the conceptual framework level with the conclusions being applied consistently to all assets and liabilities. Making changes to pensions accounting in advance of this will move the treatment of pension assets and liabilities further away than it is already from the approach to comparable liabilities, with inappropriate real world consequences.

Signed on behalf of Hewitt Associates Limited

Simon Robinson FIA
+44 (0)20 7939 4958
simon.robinson@hewitt.com

James Nicholson FIA FSA
+44 (0)117 941 6456
james.nicholson@hewitt.com

Eric Keener FSA
+1 (203) 523 8454
eric.keener@hewitt.com

Kirsten Miller FIA
+44 (0)141 551 5873
kirsten.miller@hewitt.com

Appendix

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?

No, we do not believe there are additional issues in relation to IAS 19 which should be addressed by the Board as part of this project due to their urgency.

In fact, as discussed in more detail later in our comments, we believe that the scope of the current (short-term) project should be narrowed and the following issues deferred to the IASB's proposed Phase 2 project, considering a comprehensive review of pension accounting:

- Presentation of the change in defined benefit liabilities;
- Definition of contribution-based promises;
- Treatment of "higher of" promises.

Finally, we believe that the IASB's proposed Phase 2 project to conduct a wider review of pensions accounting in conjunction with the FASB should be deferred until mark-to-market accounting is being implemented for all comparable assets and liabilities – see question 2 below.

Question 2:

Are there factors that the Board has not considered in arriving at its preliminary views [on the recognition of defined benefit promises]? If so, what are those factors? Do those factors provide sufficient reason for the Board to reconsider its preliminary views? If so, why?

While some of the proposals in both Chapter 2 and later in the Discussion Paper appear to follow logically from the arguments presented in the paper it is our understanding that these arguments are based on premises that are not applied in other areas of accounting.

In our opinion, the Discussion Paper selectively compares the recognition of gains and losses to the treatment of some (but not all) categories of financial instruments as per IAS 32 and IAS 39, but omits to note that many other comparable long term assets and liabilities:

- are not marked to market at all, requiring neither immediate nor delayed recognition of gains or losses anywhere in the financial statements
- are measured including allowance for credit risk (often implicitly) –but not for changes in credit risk
- have far more limited disclosure requirements

In particular, it is hard to distinguish in nature between the commitment made by a company to its bondholders and the commitment made in the form of pensions for former employees. (The dependence of pensions on life expectancy, whilst frequently in the news at present, has a relatively small impact compared with the effect of movements in interest rates.)

We believe that the different treatment of pension assets and liabilities compared with other corporate assets and liabilities is an important issue. It makes pension obligations appear riskier than other corporate obligations. This can mislead management and investors, guiding them to sub-optimal decisions.

The IASB has stated that it is concerned with appropriate representation of the underlying financial position, and that it cannot be swayed by the behavioural consequences. However, the behavioural consequences that affect pension plans do not result from the "fair" representation of pension plans. Instead, they result from the different treatment of pension assets and liabilities compared with other comparable long term assets and liabilities. As things stand, pension plans seem risky against a background of a generally non-volatile balance sheet. If mark-to-market accounting was consistently applied to all corporate assets and liabilities, pension plans would seem just as volatile as now, but against a background where large parts of the balance sheet (generally larger than the pension plan) were equally volatile. Accounting would no longer present pension plans as being more risky than the rest of the business, and quite possibly different decisions would be (and would have been) made. Indeed, real people may not have borne the real losses that they have on closure of pension schemes.

We do not suggest ending the marking-to-market of pension plan assets and liabilities, even though this would be more consistent with the treatment of many other similar assets and liabilities. However, we would suggest that (apart from the immediate recognition of gains and losses) there should be no further changes to the accounting for pension plans until the issues addressed in the paper (fair value, allowance for credit risk, allowance for other risk both diversifiable and non-diversifiable, marking-to-market, recognition of gains and losses, presentation of financial performance, etc) have all been addressed in comprehensive projects at the conceptual framework level with the conclusions being applied consistently to all corporate assets and liabilities – otherwise there are behavioural implications.

Despite the arguments above, we agree that it is difficult to justify deferred recognition of gains and losses, and acknowledge that the balance sheet items that result from deferred recognition are both complicated and potentially confusing.

Although this will be inconsistent with the treatment of similar assets and liabilities that are not marked-to-market at all, we therefore support immediate recognition of pension gains and losses on the balance sheet as the least bad approach available in the circumstances.

We also agree that it is difficult to justify inclusion in P&L of the expected return on plan assets as currently derived.

However, for the reasons explained in our response to question 4, we suggest retaining the subdivision of the actual return on assets into a notional expected investment return (included in P&L) and an actuarial gain or loss. This notional expected investment return could, for example, be calculated by applying the discount rate used to measure liabilities to the asset value, giving an amount that is consistent with the interest cost on liabilities and avoiding the subjectivity that is of concern with the current definition.

We do not have a strong view on the treatment of unvested past service cost. However, we disagree with the argument in paragraph 2.20 of the Discussion Paper that attributing benefit accrual in line with the plan benefit formula requires for consistency that unvested past service costs should be recognised immediately rather than over the period until they become vested. In fact, we believe the converse is the case. Attributing (unvested) benefit accrual in line with the plan benefit formula involves the recognition, over the period until they become vested, of benefits that are accrued (under the plan benefit formula) over that period. This is completely consistent with recognising unvested past service costs over the period until they become vested.

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?*

(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 do not believe that any decision about a long-term approach to the presentation of changes in defined benefit costs should be made until completion of the IASB's comprehensive project on financial statement presentation.

In the meantime, we do not support major changes away from the current approach. In particular, each of the approaches suggested is likely to be inconsistent with the conclusions of the comprehensive project, and all are certainly inconsistent with the treatment of changes to other comparable assets and liabilities. We therefore do not support any of the suggested approaches to recognising gains and losses through the performance statements.

As noted above, it is our understanding that for those corporate liabilities that are most comparable to pension liabilities (e.g. a company's own bond issues), changes in the liability are simply ignored. The liabilities are not marked-to-market at all, so the changes are not recognised in either P&L or in other comprehensive income. Approach 1 would exacerbate the difference in the treatment of pension assets and liabilities compared with similar assets and liabilities and have the effect of making them seem, by comparison, yet more volatile or more onerous compared with those other assets and liabilities. We therefore do not believe that Approach 1 is consistent with other IFRSs.

For the same reasons, we do not believe that Approach 2 is consistent with other IFRSs. We also do not recognise as meaningful the split proposed in Approach 2 between liability gains/losses relating to changes in the discount rate and other changes. For liabilities linked to inflation (or a linked parameter such as wage increases or inflation up to a cap), future inflation is just as much a financial assumption as the discount rate (and "break-even" inflation can be derived from financial markets just as directly as market yields on bonds). What matters for real liabilities is the real discount rate. If Approach 2 is to be taken further, the impact of changes in inflation as well as changes in the (nominal) discount rate should be recognised in P&L.

We assume that for Approach 3 changes in inflation are intended to be considered changes in financial assumptions and thus are to be recognised in P&L (though paragraph 3.15 of the Discussion Paper reads as if only discount rate changes and changes to the value of plan assets should be considered). If Approach 3 is to be taken further we recommend that this point be clarified.

We agree that most of the potential ways to define interest income on plan assets considered in the Discussion Paper in connection with Approach 3 are not meaningful and should not be taken further.

However, we agree with the objective mentioned for the third option in paragraph 3.29 of the Discussion Paper to use market yields at the reporting date on high-quality corporate bonds, consistent with the rate used to discount the defined benefit obligation, which will ensure that net interest on the net surplus or deficit in the defined benefit plan is recognised in P&L.

We therefore set out below in our response to question 4 our preferred Approach to presenting information on changes in pension cost.

Question 4:

(a) *How could the Board improve the approaches discussed in this paper to provide more useful information to users of financial statements?*

(b) *Please explain any alternative approach to presentation that provides more useful information to users of financial statements. In what way does your approach provide more useful information to users of financial statements?*

Since comparable assets and liabilities are not marked-to-market at all, it would be misleading to include the actual return on pension assets and other pension gains/losses in P&L unless and until accounting generally moves to marking-to-market all long-term assets and liabilities.

We agree with the argument in the Discussion Paper that interest on pension liabilities should for consistency with other IFRSs' be recognised within P&L. However, it would be misleading to recognise interest cost within P&L but not to offset this with any asset return item. (Doing so would result in showing higher profits for a company with an unfunded pension scheme than for one with a funded scheme: a company with an unfunded scheme would include in P&L higher interest on cash or lower interest on borrowings than the equivalent company with a funded scheme, and the company with the funded scheme would lack any balancing item in respect of the return on pension assets.)

Instead, we would suggest including in P&L a notional expected investment return calculated as the asset value multiplied by the discount rate used to measure the liabilities (similar to the third option described in paragraph 3.29 of the Discussion Paper). This is a more objective amount than the expected return on plan assets as currently required under IAS 19 as it treats assets and liabilities consistently. It also avoids increasing the discrepancy between the treatment of pension assets and that of the many types of long term assets and liabilities measured at amortised cost using the effective interest method. The difference between this expected return and actual return, and other pension gains/losses, would be recognised through other comprehensive income.

This approach ensures consistency in P&L between entities with funded and unfunded schemes. (A company with an unfunded scheme would include in P&L higher interest on cash or lower interest on borrowings than the equivalent company with a funded scheme, but the company with a funded scheme would instead include an equivalent amount in respect of the notional expected return on pension assets.)

While recognising pension gains and losses at all is inconsistent with not marking-to-market comparable assets and liabilities, recognising them through other comprehensive income is less inconsistent than recognising them through P&L.

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?

No we do not agree that the Board has identified the appropriate promises to be addressed in the scope of this project.

We acknowledge that the current accounting for defined contribution (DC) and defined benefit (DB) plans is inconsistent and that certain benefit designs do not fit very well into the current definitions of DC and DB (e.g. plans that are mainly DC but include an underlying guarantee which under current IAS 19 definitions makes them DB).

However, the difference arises from the fundamental fact that DC plans are accounted for on a risk-free basis, while DB plans are accounted for allowing for a standard (AA) level of credit risk. As long as this remains the case, it is necessary to define a boundary determining which plans get accounted for in which way. Although it is not ideal, we believe that the only defensible boundary is between pure funded (and perfectly matched) DC plans and all other plans, ie where it currently is under IAS 19. Any attempt to draw another boundary will lead to further inconsistencies, such as very different accounting treatment for two plans which are almost identical (in some cases economically identical, but presented differently).

IASB staff have been wrestling with this problem for several years now, and we believe it is not soluble as long as the accounting for pure DC and final salary plans remain as they are.

Accordingly, we believe that the IASB should defer any attempt to change fundamentally the accounting for any category of pension benefits before first undertaking a comprehensive review of pensions accounting as a whole, and that this review itself should be deferred until:

- the definition of “fair value” has been addressed for assets and liabilities that are not traded, including the treatment of risk (both diversifiable and non-diversifiable), and is being applied to all comparable assets and liabilities
- mark-to-market accounting is being implemented for all comparable assets and liabilities
- the treatment of credit risk has been resolved as a matter of principle and is being implemented in a consistent way across accounting for all liabilities
- the project on financial statement presentation (including the treatment of gains and losses) has reached a conclusion and is being

implemented

On a more detailed level, paragraph 4.9 of the Discussion Paper notes that the IFRIC was informed that attribution of benefits to periods of service generated questions in relation to some plans that promise benefits related to current year salary (or contributions derived from current salary) with subsequent revaluation or returns in line with some index or asset value. Some question whether future salary increases should be allowed for in assessing whether the plan formula attributes higher benefits to later periods of service.

We agree this is a valid issue. However, we can see no connection between this issue and the proposals in the Discussion Paper to introduce a definition of contribution-based promises with a completely new accounting treatment. Exactly the same issue would arise in relation to contribution-based promises as defined in the Discussion Paper – except that the IASB has simply omitted for contribution-based promises the requirement to allocate benefits on a straight line basis where the plan formula would allocate materially higher benefits to later periods.

The IASB has given little justification for this omission except that it would change the accounting treatment for plans that would currently be classed as defined contribution. The IASB has given no reason why it is more important to maintain the accounting treatment for plans that are currently classed as defined contribution than for plans that are currently classed as defined benefit, and has not discussed the arguments for and against such a straight line attribution requirement in relation to any type of promise. We believe that the existing requirement in relation to defined benefit plans is targeted at plans where there is step change in the plan benefit formula (for example where the accrual rate is 1% of final pay for each of the first 10 years of service, increasing to 2% of final pay thereafter), rather than at the impact of salary increases on plans with a flat benefit formula. The reasons for straight line allocation of benefits for plans with such a step change in the benefit formula apply just as much to: (1) plans that are currently defined benefit but would be re-categorised as contributions based; as to (2) plans that will, under the proposals, remain categorised as defined benefit.

We believe that the issue could be resolved in a straightforward way by the IFRIC or the IASB clarifying that the existing requirement does not require consideration of future salary increases in assessing whether a plan formula allocates a materially higher benefit to later periods of service. We do not believe that it has any relevance in motivating the creation of a new category of benefit promises with a completely new accounting treatment as suggested in the Discussion Paper.

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?

Yes, we believe many plans would be reclassified. Some jurisdictions will be impacted more than others depending on the predominant types of plans, but we believe that in a number of countries, e.g. Germany, the Netherlands, Switzerland and the United States, the majority of plans currently classified as defined benefit could be considered contribution-based under the current proposals.

As explained above, the proposals create an artificial distinction between categories of pension benefits that are almost identical (in some cases economically identical) but presented differently. The table below shows just a few examples illustrating this:

Contribution-based	Defined benefit
Promise of 1,000 at retirement for a deferred pensioner who participated in a career average salary plan	Promise of 1,000 at retirement for a deferred pensioner who participated in a final average salary plan
Plan which defines pension based on average of all years' salary	Plan which defines pension based on average of up to 40 years' salary
This year's accrual under plan formula based on this year's salary	This year's accrual under plan formula based on 50% (or 90% or 99%) of this year's salary and 50% (or 10% or 1%) of next year's salary

The benefits shown in the first column above may be virtually identical to those shown in the second column. However, under the proposals in the Discussion Paper, these benefits would be treated very differently, leading a company to recognise completely different balance sheet liabilities (and potentially have different financial statement presentation of the liabilities and the associated expense), depending on whether the benefit is categorised as contribution-based or defined benefit.

We do not believe that it is possible to justify in any rational way the differences that will result.

Furthermore, the proposed accounting treatment for plans that would be re-categorised as contribution-based would make them look far more onerous and volatile than comparable liabilities. This would mislead management and investors, guiding them to sub-optimal decisions, with real world impacts on employees.

Question 7:

Do the proposals achieve that goal [of limited impact on plans currently classed as defined contribution]? If not, why not?

We have not yet identified any impact of the proposals on plans that are currently classed as defined contribution.

Question 8:

Do you have any comments on those preliminary views [regarding the recognition for contribution based promises]? If so, what are they?

We generally agree that both vested and unvested benefits should be recognised as a liability, and that benefits earned should be allocated to periods of service in accordance with the benefit formula.

However, we note that the proposal to require attribution for contribution-based promises in accordance with the plan benefit formula (without consideration as to whether this leads to allocating materially higher benefits to later periods) will lead to further differences in the treatment of contribution-based promises compared with defined benefit promises (i.e.

different treatment between categories of pension benefit that are almost identical and in some cases economically identical) and we do not believe this can be justified.

We also note that, for any plan that appears to meet the definition of a contribution-based promise but is back loaded in any way, requiring straight line allocation could actually make the benefit attributed to past service salary related (by including a pro-rata portion of benefits that will be earned in future years based on future years' salaries). This would then imply that the plan should not be considered contribution-based at all, demonstrating the fragility of the proposed definitions

---

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 promises project? How should this be done?*

We are unclear how the justification for the measurement objectives presented in the Discussion Paper was determined. The objectives do not appear to be :

- derived from the Conceptual Framework;
- justified in the Discussion Paper itself; and
- they are not applied in the measurement of comparable liabilities (not even final salary pension liabilities).

We do not therefore believe that it is appropriate to measure the proposed measurement approach against those objectives.

In particular, the question as to how risk should be allowed for in relation to pension liabilities should be considered only once allowance for risk (including credit risk) has been resolved at a conceptual level and is being implemented for the measurement of all comparable liabilities and in the same way as for those liabilities. Reflecting risk in the annual re-measurement of some categories of pension liabilities in advance of doing so for other comparable liabilities will make pension liabilities look far more onerous and volatile than such comparable liabilities. This will mislead management and investors, guiding them to sub-optimal decisions, with real world impacts on employees.

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 phase at fair value assuming the terms of the benefit promise do not change?*

We do agree that there should not be a change in the measurement approach as beneficiaries pass from employment to deferred status or from deferred status to payment. However, we also believe that two identical benefits that both are in the payout or deferment phase should have identical liabilities regardless of how those benefits were accumulated.

We do not see how measuring the liabilities for identical benefits in different ways depending on past history that is no longer relevant (i.e. whether the benefits arose from a defined benefit promise or a contribution-based promise) can possibly be justified. This further illustrates the inconsistencies that would arise from requiring completely different accounting treatment for the two types of promises.

It is our opinion that, if the thought process behind the Discussion Paper has led to a result that requires either: (1) a change in measurement approach on a change in status; or (2) liabilities for identical benefits to be measured differently; then there is a flaw in that process and it should be re-visited.

Further, we note that many benefit plans have been formed from mergers of or transfers from many predecessor benefit plans. Whilst the managers of those plans know the benefits to which members are entitled, they do not always know how those benefits were built up, making the proposed approach impossible to implement in practice.

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?

For promises that are not defined contribution promises (under the current definition) the same level of detail as for defined benefit promises is both useful and possible (because it is being provided now).

For plans that are defined contribution promises (under the current definition) many of the items provided for defined benefit promises are redundant (because for example interest cost and return on assets are automatically equal and opposite, and gains/losses are automatically nil).

It is classifying two fundamentally different types of promise as contribution-based that makes some of the disaggregation difficult for some of the promises, i.e. the problem is with the categorisation of benefit promises, not with the disclosure requirements.

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)?

In our view, to ensure comparability of financial statements, it is important that different companies report like items in the same way. Similarly, we believe that a single company with multiple plans should report like items in the same way across plans.

In particular, for plans that are not defined contribution promises (under the current definition), the measurement and presentation of changes in the liability should be the same as for defined benefit plans – because that is what they are.

Requiring otherwise could result in a lack of comparability between two companies that have made virtually identical benefit promises. It could also result in a single company holding two very different liabilities for two virtually identical benefit promises, and reporting changes in those liabilities in two very different ways. This would be both misleading and confusing to users of financial statements.

Question 13:

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

We understand that IASB staff have commented that pension actuaries already use option pricing and stochastic approaches – for example, in connection with the measurement of pension promises subject to guaranteed increases in line with inflation but with a minimum and/or maximum increase (a collar and/or cap) or in connection with asset liability studies. This is indeed the case. However, we note that:

- pension promises subject to pension increases with caps or collars can be measured using a closed form solution – there is no need to run stochastic projections; instead a relatively simple formula can be used to derive the mean level of annual pension increases for such a promise from break-even inflation and inflation volatility (which can both be derived from market prices on swaps)
- asset liability studies are carried out at the level of the whole scheme, not for individual members

In contrast we note that measurement of "higher of" promises would in general:

- have to be carried out for each individual member and not at the aggregate scheme level
- require stochastic simulation for each member (there will not always be a closed form solution)
- require full calculations starting from individual member data at each balance sheet date (at interim reporting dates as well as at the financial year end). While defined benefit liabilities for the plan as a whole can readily be approximately rolled forward to each balance sheet date and compared with the asset value at that date, it will not be possible to roll forward the aggregate for the plan of the option value of "higher of" guarantees, which are very sensitive to the relative size for each individual member of the two liability measures at the balance sheet date

To judge what would be involved if the suggested approach was implemented, we suggest considering the calculations implied by projecting forward the assets and two different pension promises for 40 years for say 1,000 stochastic runs for each of the tens of thousands of members of a pension plan. And consider gathering the data required for each of these members at the balance sheet date from the plan administrator and performing (and checking) the required calculations all before the accounts are finalised, possibly just a few weeks after the balance sheet date.

All this means that while the approach set out in the paper is possible in theory, in practice the costs of pension cost calculations will be (literally) several orders of magnitude higher than now, and are unlikely to be possible within the timescale available from the balance sheet date to the date on which the accounts are finalised.

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

We note that the statement in the Discussion Paper that the Board believes that measurement of "higher of" options at intrinsic value – as is normal under the current requirements of IAS 19 – may understate the value of the option.

We agree that this is possible – but note that the measurement of pension liabilities is already several steps further towards marking to market at fair value than for comparable liabilities (as discussed in more detail above in the response to question 2). This difference in the treatment of comparable liabilities is already making them look far more onerous and volatile than comparable liabilities. This is already misleading management and investors, guiding them to sub-optimal decisions, with real world impacts on employees.

It is therefore inappropriate to further increase the difference in treatment between pension liabilities and other comparable liabilities. Instead, attention should be directed at narrowing the difference. Once marking-to-market at fair value (and allowing for any embedded options) is being implemented for all comparable liabilities, it will make sense to adopt a similar more purist approach for pension liabilities.

We note further that applying option valuation to the excess of a "higher of" defined contribution promise over a defined benefit promise can give smaller rather than larger liability values than the intrinsic value approach which is commonly adopted now. This is due to the allowance for credit risk on defined benefit promises, as explained in the following example.

Example

A plan promises an employee currently aged 50 a lump sum equal to the greater of:

- 1,000 on retirement at age 60
- the accumulation of a defined contribution account invested in a government zero coupon bond which will mature in 10 years time with proceeds of £1,000.

The 10 year AA discount rate is 5%.

So the value of liabilities on a defined benefit basis is 614 (= 1,000/1.05^10).

With a government bond yield of 4% pa, the market value of the zero coupon bond is 676 (= 1,000/1.04^10).

On the approach generally adopted now (taking a higher of option at intrinsic value), the value of liabilities is taken at the greater of 614 and 676, i.e. at 676.

On the proposed approach, the value would be the defined benefit value (614) plus the option value of the excess of the defined contribution maturity proceeds over the defined benefit promise (nil) ie 614.

This example shows a degenerate option for simplicity. However, the same principles will apply for “real” cases. In effect, by starting with the DB value, and then looking at the option value of the DC excess, the proposed approach applies a reduction in respect of non-existent credit risk to the first tranche (of an amount equal to the DB value) of the defined contribution account. If this reduction in value exceeds the option value of the excess (which it often will), the approach will give a smaller overall value than the current intrinsic approach.

We therefore believe that, in some cases, the IASB’s concern that the intrinsic approach understates the real value of the liability may be unfounded.

Question 14: *What disclosures should the Board consider as part of that review?*

Disclosure principles should be applied consistently across all significant long-term assets and liabilities. The demand from some investors for more disclosure relating to pensions has arguably been generated by the inconsistent treatment of pensions compared with other long-term assets and liabilities, which makes pension liabilities seem more risky (relative to those other assets and liabilities) than in reality they are. If those other assets and liabilities were treated consistently, and similarly marked-to-market, there would be a more balanced assessment of the need for disclosure relating to different assets and liabilities.

There are many assets and liabilities where different measures would give different values. It would therefore be inconsistent to require disclosure of more than one measure of pension liabilities (such as the suggestion to require disclosure of the "buy-out" cost) without requiring similar disclosures for other liabilities.

The UK Accounting Standards Board has suggested extensive disclosure in corporate accounts of the powers of the trustees or managers of an entity's pension plans. Contractual arrangements between the entity and its suppliers, customers and banks are not disclosed in the accounts, and we understand that confidential provisions within such agreements are often of far more significance than the provisions governing pension plans. Requiring disclosure of the “contract” between the entity and the trustees/managers would therefore be inappropriate. (Just the fact of disclosing powers that plan trustees have in extreme situations can - inappropriately and with adverse behavioural consequences - make a pension plan seem relatively risky compared with other long-term assets and liabilities where there is no disclosure of similar provisions.) Further, such disclosures would be impractical (within any reasonable length of financial statements) for a group with multiple plans across different countries, where there can be no objective measure of what plan provisions would be “usual” (across country borders) and since little aggregation of the disclosures across plans would be possible because of different local law.

Similarly, there is no requirement to disclose expected cashflows for other long-term assets and liabilities, so it would be unduly onerous to require disclosure of a pension plan’s expected cashflows (but see below in respect of aggregated data over the short term). In any case, it is surely the expected funding (not accounting) cashflows from the entity to the plan that matter to users of the accounts, rather than the cashflows within the plan itself, and these cashflows are generally easier for the entity to adjust in the light of the entity's financial state than is the case for other long-term liabilities.

Requiring disclosure of aggregate contributions to the group's pension plans over the next year or two is sensible. Beyond this period, actual employer contributions are so uncertain that disclosure would be misleading. Disclosure of funding agreements would be simply impractical (within any reasonable length of financial statements) for a group with multiple plans across different countries.

The disclosures about risk exposures and management should be required – where material – by general accounting standards (such as IAS 1) rather than setting out extra requirements for pensions.

In relation to the specific issue raised by the Discussion Paper, we note that IAS 19 already requires disclosure of significant assumptions, which would include the post-retirement mortality assumption (where relevant). However, we agree that it would be helpful to require disclosure of standard metrics (such as for example life expectancy for a 65 year old retiring now or in 10, 20, and 30 years time) rather than references to actuarial tables that may not be meaningful except to actuaries.

Question 15:

Do you have any other comments on this paper? If so, what are they?

Over recent years, IASB staff have made a number of attempts to draw an arbitrary line by dividing plans that are currently classified as defined benefit into two different categories. The proposed definition of contribution-based promises in the Discussion Paper is the latest in this series of attempts. We believe that as long as defined contribution plans (as currently defined) are measured on a risk-free basis (as is appropriate) while defined benefit plans are measured with an implied allowance for credit risk, such attempts will not succeed in achieving the IASB's objectives.

Until the IASB addresses underlying issues at the conceptual framework level, the only workable division is is the current one – between pure defined contribution plans and all other plans.

As explained above, we believe a mixed model that measures: (1) contribution-based promises that are currently considered defined benefit; differently from (2) all other defined benefit promises; cannot be justified for conceptual as well as practical reasons. We also believe that applying option valuation to the excess of a "higher of" defined contribution promise over a defined benefit promise can result in smaller liability values than the intrinsic value approach which is commonly adopted now, due to the allowance for credit risk on defined benefit promises.

Some of the difficulties with the proposals in the Discussion Paper would disappear if the measurement of defined benefit plans was also reviewed. However, we believe that this review should not be done in isolation. Rather, it should occur after underlying issues such as fair value, allowance for credit risk, allowance for other risk, marking to market, recognition of gains and losses, and presentation of financial performance have all been addressed at the conceptual framework level and the conclusions have been applied consistently to other long-term assets and liabilities.