The Hundred Group
of Finance Directors

Financial Reporting Committee

Anne McGeachin
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International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

26 September 2008

Dear Anne

Discussion Paper – Amendments to IAS 19 "Employee Benefits"

We are pleased to submit our comments on the above proposals.

Who we are

The Hundred Group of Finance Directors represents the views of the finance directors of the UK's largest companies drawn largely, but not entirely, from the constituents of the FTSE100 Index. Our members are the finance directors of companies whose market capitalisation collectively represents over 80% of companies listed on the London Stock Exchange. Views expressed in this letter are those of The Hundred Group of Finance Directors but are not necessarily those of our individual members or their respective employers.

Summary of our views

Scope of the project

We understand that the Discussion Paper is intended to address a number of short-term issues pending the longer term development with the FASB of a common standard on post-employment benefits.

We therefore believe that the scope of the Discussion Paper is too broad. In particular, we believe that the re-categorisation of post-employment benefits between "defined benefit promises" and "contribution-based promises" and the proposed use of fair value to measure contribution-based promises represents a fundamental reconsideration of the principles of IAS 19 "Employee Benefits" that should be considered within the scope of the long-term project with the FASB.

We are also concerned that the Discussion Paper considers the presentation of pension costs. We believe this is premature pending the Board's imminent proposals on financial statement presentation.

We suggest that the short-term project should address only the full recognition of the value of plan assets and benefit obligations and the provision of a short-term accounting solution in respect of defined contribution schemes with a guaranteed minimum return or clearly circumscribed risk that have become more common in recent years.

Removal of the corridor method

We support the Board's proposal that all changes in the value of plan assets and benefit obligations should be recognised in the financial statements in the period in which they occur, i.e. removal of the corridor method.

We stress, however, that our support is offered in the context of the existing accounting model which reflects the long-term nature of post-employment benefits.

Consistent with our support for the removal of the corridor method, we agree that there should be no deferral of unvested past service costs.

Presentation of pension costs

We believe that it is premature for the Board to consider changing the basis on which pension costs are allocated between profit and loss and other comprehensive income until it has concluded its project on financial statement presentation.

We believe that the presentation project should give special consideration to the long-term nature of post-employment benefits and the reasons why the current allocation of pension costs has developed, i.e. in order that profit or loss reflects the cost of benefits provided in the period and to protect it from short-term fluctuations in relation to long-term assets and liabilities.

With the exception of eliminating the corridor and requiring the immediate recognition of past service costs, we do not see any advantage in changing the presentation currently required under IAS1 and IAS19.

We therefore do not support the Board's preliminary view that the actual return on plan assets should be reported in profit or loss.

Similarly, we do not wholeheartedly support any of the three alternative approaches presented in paragraphs 3.10 to 3.16 of the Discussion Paper with regard to the presentation of actuarial gains and losses. Of the three approaches our preference would be for Approach 3 whereby remeasurements arising from changes in financial assumptions are recognised in other comprehensive income and all other changes are recognised in profit or loss. However, we have misgivings even about Approach 3. We do not understand the logic for including changes in financial assumptions in other comprehensive income and changes in non-financial assumptions (e.g. mortality) in profit or loss. We believe that pending conclusion of the presentation project all remeasurements in relation to post-employment benefits should continue to be recognised in other comprehensive income, i.e. consistent with the current requirements of IAS1 and IAS19.

Given the proposals on actuarial gains and losses would cause a significant change in presentation, we believe they should have been given more prominence in the Discussion Paper.

Contribution-based promises

We are concerned that the proposed definition of contribution-based promises is too broad such that it would result in a fundamental change in the accounting for a significant number of plans that are currently classed as defined benefit plans in order to provide an accounting solution for relatively few plans.

While the definition would include all schemes that are currently classified as defined contribution schemes we are concerned that certain plans (in particular, career average salary plans) that in our view are in substance defined benefit plans would be classified as contribution-based promises.

We recognise that narrowing the definition of a contribution-based promise would result in only a limited number of promises being addressed by the proposals. However, we believe that this would be more appropriate in the context of a short-term project that should not fundamentally change the principles of current IAS19.

We suggest that a more practical short-term approach would be to permit plans which are basically defined contribution plans with an added, easily circumscribed risk (e.g. minimum guaranteed return) to be accounted for as a defined contribution plan plus a separately valued element. If this more pragmatic approach is not considered by the Board to be appropriate, we do not believe that there should be any change to the current classification of pension schemes pending the conclusion of the long-term project on post-employment benefits.

Convergence with US GAAP

We are not aware that the FASB has issued (or has plans to issue) an equivalent Discussion Paper that would introduce the notion of the contribution-based promise. We are therefore puzzled that the Board has pursued this aspect of its proposals as it would create a *new* difference between IFRS and US GAAP.

Please feel free to contact me if you would like to discuss our comments.

Yours sincerely

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RESPONSES TO SPECIFIC QUESTIONS

Scope of the Project

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?

We certainly do not think there are any *additional* issues which should have been addressed by the Board.

We believe that the scope of the Discussion Paper is *too broad* as it seeks to make fundamental changes (in particular, introducing the new category of "contribution-based promises") that should be considered in the context of the long-term project with the FASB to develop a common standard on post-employment benefits.

Recognition and presentation of defined benefit promises

Question 2

Are there factors that the Board has not considered in arriving at its preliminary views [with respect to 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?

Removal of the corridor approach

We agree with the proposal to recognise all changes in the value of plan assets and post-employment benefit obligations in the financial statements in the period in which they occur (i.e. removal of the corridor deferral method).

We stress, however, that our support is offered in the context of the existing accounting model which reflects the long-term nature of post-employment benefits. We would need to revisit this conclusion if fair value were used to measure contribution-based promises.

Past service costs

We also agree that unvested past service costs should be recognised in the period of the plan amendment.

We recognise that the Board identifies in paragraph 2.20 of the Discussion Paper, that immediate recognition is perhaps inconsistent with IFRS 2 "Share-based Payment" but we support immediate recognition as it is consistent with the proposal for immediate recognition of all changes in the value of plan assets and post-employment benefit obligations in the financial statements in the period in which they occur.

Expected return on assets

We do not support the Board's preliminary view that the actual return on plan assets should be reported in profit or loss.

In practice, the management of pension funds (in particular, funding decisions), is usually based on the expected return on assets over the long term. In addition, we believe that users try to identify underlying sustainable earnings. We therefore believe that it is neither appropriate nor helpful to users to subject profit or loss to potentially substantial and volatile differences between actual and long-term expected returns.

We suggest that this issue should be considered as part of the longer-term project and should not be addressed by the short-term amendments.

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 others, 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 believe that it is premature for the Board to consider changing the basis on which pension costs are allocated between profit and loss and other comprehensive income until it has concluded its project on financial statement presentation.

We believe that the presentation project should give special consideration to the long-term nature of post-employment benefits and the reasons why the current allocation of pension costs has developed, i.e. in order that profit or loss reflects the cost of benefits provided in the period and to protect it from short-term fluctuations in relation to long-term assets and liabilities.

With the exception of eliminating the corridor approach and requiring the immediate recognition of past service costs, we do not see any advantage in changing the presentation currently required under IAS1 and IAS19.

We do not wholeheartedly support any of the three alternative approaches presented in paragraphs 3.10 to 3.16 of the Discussion Paper with regard to the presentation of actuarial gains and losses. Of the three approaches, our preference would be for Approach 3 whereby remeasurements arising from changes in financial assumptions are recognised in other comprehensive income and all other changes are recognised in profit or loss. However, we have misgivings even about Approach 3. We do not understand the logic for including changes in financial assumptions in other comprehensive income and changes in non-financial assumptions (e.g. mortality) in profit or loss. We believe that pending conclusion of the presentation project all remeasurements in relation to post-employment benefits should continue to be recognised in other comprehensive income, i.e. consistent with the current requirements of IAS1 and IAS19.

Given the proposals on actuarial gains and losses would cause a significant change in presentation, we believe they should have been given more prominence in the Discussion Paper.

Whichever approach is adopted, we believe that a single figure aggregating all remeasurement gains and losses would be of little help to users because it would contain elements that are very different in nature and hold different predictive value. We believe that users require detailed information to allow them to conduct their own sensitivity analysis on pension costs. We therefore recommend that remeasurement gains and losses should be required to be disaggregated in the notes to the financial statements.

We do not believe that particular difficulties would arise in applying any of the presentation approaches. In our experience, actuaries are well versed in analysing the changes in the pension liabilities recognised under accounting standards.

<u>Question 4</u>

(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?

See our answer to Question 3.

<u>Definition of contribution-based promises</u>

<u>Question 5</u>

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 believe that the proposed categorisation of benefit promises (defined benefit vs. contribution-based promises) represents a fundamental reconsideration of the principles of current IAS 19 and, as such, goes beyond the desirable remit of the short-term project on post-employment benefits.

We are concerned that the proposed definition of contribution-based promises is too broad such that it would result in a fundamental change in the accounting for a significant number of plans that are currently classed as defined benefit plans in order to provide an accounting solution for relatively few plans.

Under the existing IAS19, the definition of a defined contribution scheme is based on the premise that contributions representing the entity's obligation are paid into a separate fund outside the control and risk of the entity. We consider the existing definition and the related accounting requirements to be clear and simple.

The Board's proposed definition of a contribution-based promise requires that the contribution for any period of service is known at the end of that period, except for the effect of any vesting or demographic risks. Accordingly, risks in the accumulation phase are limited primarily to asset-based risks. Benefit promises with salary risk are specifically excluded from contribution-based promises. While this definition would include all schemes that are currently classified as defined contribution schemes we are concerned that certain plans (in particular, career average salary plans) that in our view are in substance defined benefit plans would be classified as contribution-based promises.

The Board argues that a career average scheme has the same economic effect as a guaranteed return of 0% on contributions and should therefore be classified as a contribution-based promise. While we acknowledge the theory, we are not satisfied that the career average scheme is sufficiently different in substance from a final salary scheme to warrant a different accounting treatment. While it is true that the career average scheme is not subject to salary risk, it is subject to very similar vesting risk, demographic risk and credit risk as a final salary scheme. We believe that both should be classified as defined benefit promises and the pension obligation measured using similar assumptions and techniques.

We suggest that a more practical short-term approach would be to permit plans which are basically defined contribution plans with an added, easily circumscribed risk (e.g. minimum guaranteed return) to be accounted for as a defined contribution plan plus a separately valued element. If this more pragmatic approach is not considered by the Board to be appropriate, we do not believe that there should be any change in the current classification of pension schemes pending the conclusion of the long-term project on post-employment benefits.

<u>Question 6</u>

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?

We believe that a significant number of schemes would have to be reclassified (in particular, those schemes providing a specified return on contributions or other guarantees, career-average schemes and schemes with "higher of" options).

We are concerned that there will be practical difficulties in obtaining an appropriate mix of actuarial and business valuation skills to measure the affected schemes on the proposed basis.

<u>Question 7</u>

Do the proposals achieve that goal [of not making changes to accounting to most promises that currently meet the definition of defined contribution plans in IAS 19]? If not, why not?

We agree that the proposals would not change the accounting for most promises that meet the current definition of defined contribution plans.

<u>Recognition issues related to contribution-based promises</u>

<u>Question 8</u>

Do you have any comments on those preliminary views [for recognition issues related to contribution-based promises summarised in PV9 to PV11]? If so, what are they?

With the proviso that we do not think that the short-term project should address the re-categorisation of benefits, we agree with the following proposals on how to recognise contribution-based promises (on the basis that they are broadly consistent with current IAS19 and therefore would not change the accounting for most promises that meet the current definition of defined contribution plans):

- Both vested and unvested contribution-based promises should be recognised as a liability;
- Benefits earned under a contribution-based promise should be allocated to periods of service in accordance with the benefit formula;
- A liability should not be recognised in relation to the additional amount that an employer would pay when an employee leaves employment immediately after the reporting date.

<u>Measurement of contribution-based promises</u>

<u>Question 9</u>

(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 do not welcome the proposal that benefit promises that meet the definition of contribution-based promises should be measured at fair value as we believe that it would introduce inconsistency in the measurement of promises that are similar economically, e.g. a career average plan (that would be measured at fair value) compared with a final salary plan with benefits based on the last 10 years' service (that would be measured using the projected unit credit method).

Even if the Board were to narrow the definition of contribution-based promises, we would have some fundamental concerns over how to measure benefit promises at fair value. In our view, if the Board proceeds with the fair value measurement approach it must provide guidance on its application in the context of post-employment benefits, e.g. on how to incorporate demographic risk into the fair value measurement.

We understand that the Board proposes to incorporate credit risk, being the risk of non-payment of a benefit (not just the entity's own insolvency risk) into the fair value measurement of contribution-based promises. We are concerned that this not only precedes the development by the Board of any general requirement to reflect own credit risk across all similar arrangements, e.g., insurance contracts, but also would cause there to be a difference between the rate used to discount defined benefit promises (the market yield on high quality corporate bonds) and that used to discount contribution-based promises. We do not believe that the Board has justified this inconsistency and we would rather that own credit risk is excluded from the discount rate because it would reduce comparability between entities.

<u>Question 10</u>

(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?

With the proviso that we do not think that the short-term project should address the re-categorisation of benefits, we agree with the Board's preliminary view that the liability should be measured in the same way during the deferment and payout phases as during the accumulation phase as it is not helpful for there to be a change in measurement as employees pass into the deferment or payout phase of the promise.

We do not believe that fair value assuming the terms of the benefit do not change should be adopted as a measurement basis at the payout phase, though we do not see any particular difficulties in measuring the liability during the payout phase which do not exist during the accumulation phase.

Disaggregation, presentation and disclosure of contribution-based promises

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?

With the proviso that we do not think that the short-term project should address the re-categorisation of benefits, we disagree that changes in a liability for a contribution-based promise should be disaggregated only into a service cost and other value changes. Whilst it may be difficult, we believe it appropriate to analyse the changes in the liability for contribution-based promises in the same way as those for defined benefit promises.

Question 12

Should changes in the liability for contribution-based promises:

(a) be presented in profit and 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?

With the proviso that we do not think that the short-term project should address the re-categorisation of benefits, we believe that the changes in the liability for contribution-based promises should mirror the presentation of changes in the liability for defined benefit promises. We believe that if the Board proceeds with different presentation approaches for defined benefit and contribution-based promises, then the reasons for having different presentation approaches should be provided.

Benefit promises with a 'higher of' option

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?*

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

While we believe that the accounting treatment proposed for benefit promises with a "higher of" option makes sense intuitively and is consistent with the treatment of financial options in IAS39, we suggest that the Board obtains input from valuation specialists with regard to the practical difficulties of measuring "higher of" options.

Other matters

Question 14

What disclosures should the Board consider as part of that review?

Whilst we do not have any comments on specific disclosures at this stage we must stress the importance of not increasing the overall level of pensions disclosures. In our experience, pensions disclosures in most annual reports are already very extensive and there is the risk that the more information that is added, the less transparent it will become.

We suggest that the Board refers to the ASB's Reporting Statement "Retirement Benefits – Disclosures"

Question 15

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

We have no further comments.