Summary of Comments

<u>Introduction of the new category “contribution-based promises”</u>

In our view the proposal to introduce a new category “contribution-based promises” seems to be contradictory to the Boards’ initial intention to find an immediate solution primarily for promises that are linked to an actual or notional return on assets. In combination with the proposed fair value measurement, it should be stressed that this would have a significant impact on the way companies present their pension obligations in financial statements and management reporting, as investors generally focus on the underlying operating result. In addition the introduction of this new category “contribution-based promises” clearly contradicts further steps towards conversion. Therefore we suggest maintaining the current classification of pension plans and seeking a pragmatic solution to accounting for the promises described in this first phase of the project (see also our answer to Question 5).

<u>Elimination of existing options for the recognition of changes in defined benefit promises</u>

We generally agree with the Board that the existing options for the recognition of changes in defined benefit promises should be eliminated, but we believe that a distinction has to be made between recognition in the balance sheet and recognition in the income statement. While we support the immediate and full recognition of the net surplus or deficit from defined benefit obligations and plan assets in the balance sheet to reflect the full asset status, we have some concerns regarding the recognition of certain components of the changes resulting from recognition in profit or loss rather than in OCI. The reasons for our opinion concerning this issue are outlined in our answer to Question 2.

<u>Involvement of IASB in a number of significant projects</u>

Besides the issues discussed above, we would like to point out that the IASB is currently involved in a number of significant projects, which have to be taken into account in judging many of the issues underlying the proposals in this DP. Especially the projects on Fair Value Measurement, Insurance Contracts, the Conceptual

Framework and Financial Statement Presentation have to be considered. Decisions taken at this stage as part of this project may require subsequent revision depending on the outcome of the other projects. Moreover, we are of the opinion that regard has to be paid to the measurement of contribution-based promises proposed in this DP and the measurement principles discussed in the DP “Preliminary Views on Insurance Contracts,” issued in May 2007. Otherwise, decisions resulting from these fundamental projects may require substantial revisions to pension accounting. As the DP is meant as an interim solution, one should rather concentrate on solving current practical problems than on introducing major recognition and measurement principles which might conflict with the above mentioned major IASB projects.

Answers to the questions raised in the DP

The factors causing us to disagree with the Board's preliminary intention to create a new categorisation of post-employment benefit arrangements, the new definition of "contribution-based promises" and the intended fair value measurement are discussed in detail in our answers to the questions raised in the DP.

Chapter 1: INTRODUCTION

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 do not see any additional issues which should be addressed by the Board as part of this project. On the contrary, we believe the proposed changes already go beyond the Board's aim of satisfactorily accounting for "troublesome" pension plans. In our opinion, attention should not be drawn on the discussion about a new class of plans but could focus on the question in which line items of the income statement the income and expenses related to post-employment benefit plans should be recognised to avoid heterogeneous reporting. We would recommend a consistent distinction between operating and financial income and expense. Such an approach would improve the comparability of financial statements among companies.
Concerning the distinction between operating and financial income, we think that service cost, prior service cost, and effects from curtailments and settlements should be recognised within operating income or expense while interest cost, expected return on plan assets and the amortisation of net actuarial gains (losses), if applicable, should be classified as financial income or expense.

Chapter 2: DEFERRED RECOGNITION OF CHANGES IN THE LIABILITY FOR DEFINED BENEFIT PROMISES

Question 2

Are there factors that the Board has not considered in arriving at its preliminary views? If so, what are those factors? Do those factors provide sufficient reason for the Board to reconsider its preliminary views? If so, why?

We are indeed of the opinion that there are factors which the Board has not considered in arriving at its preliminary views (PV). These factors are described in the following.

In **Preliminary View 2 (PV 2)** the Board proposed the immediate recognition of all changes in the value of plan assets and the post-employment benefit obligation in financial statements in the period in which they occur.
As already mentioned in the Summary of Comments, we support the immediate and full recognition of the net surplus or deficit resulting from defined benefit obligations and plan assets on the balance sheet. However, regarding the recognition of certain components of changes resulting from the remeasurement of plan assets and post-employment benefit obligations, which cause a short-term volatility in income, in the income statement, we do have significant concerns. These changes could seriously distort the operating result, thereby significantly lowering the quality of financial reporting. Unfortunately, as described in item 2.8 of the DP, the Board rejected these arguments although, for example, a survey conducted by Watson Wyatt in July 2008 in which 131 companies from 17 countries participated also arrived at the conclusion that 80 percent of the companies do not support immediate recognition in profit or loss.[1]

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[1] cf. Watson Wyatt (2008), Accounting for Employee Benefits - Reactions to the IASB's Preliminary Views Paper from around the World, page 2

To illustrate the potential effects of immediate recognition on the explanatory and predictive value of financial reporting, Bayer carried out some simulations for reference periods with increasing and decreasing discount rates. Assuming a full and direct recognition in profit or loss, the quarterly income after taxes as reported in the period from the beginning of 2007 to the first quarter of 2008 (a period of increasing market rates) would have been doubled or even tripled in particular quarters.

If discount rates had fallen (as for example during fiscal 2005), income after taxes would have decreased significantly. In one quarter, a profit after taxes would have been reversed into a loss of twice the amount.

Another argument which supports our concern about this proposal is the fact that the comparability of reported earnings would be adversely affected if actuarial gains and losses completely offset one another in two consecutive periods. A significant volatility in earnings leads to a limited comparability of reported earnings over a period of several years. We doubt whether this would be in line with the aim of providing useful information as required by paragraph 12 of the IASB Framework. Besides we know from our financial analysts that they would then start to eliminate the volatility arising from the full recognition in profit or loss by pro forma calculations in order to obtain amounts with predictive quality.

Moreover, it has to be taken into account that the short-term volatility risk for earnings does not necessarily reflect the long-term risk situation of the benefit plans. If reporting entities tried to control the short-term volatility risk for earnings, they could be forced to make economically inefficient decisions. Compensation packages provided by companies would be significantly amended by closing existing benefit plans. This could cause serious distortions in different segments of the capital market if many plan sponsors shift their allocation of plan assets - for example by introducing liability-driven investment concepts - in order to reduce accounting volatility.

The Board replied to the arguments against the “all through profit or loss” approach by pointing out that inappropriate accounting should not be continued in order to disguise the true state of defined benefit plans as the role of accounting is to report transactions and events in a neutral manner (see item 2.8 of the DP).

We share the opinion that the net position of a plan determined as the difference between post-employment benefit obligation and plan assets reflects the true state of the plan and is therefore a good solution for purposes of recognition in the balance sheet. Concerning the income statement, however, we do not agree with the Board's conclusion. As the fair value measurement of the net position of a plan implies an immediate settlement of all existing plan liabilities, although the standard assumption for providing the promised benefits is to continue the plan, it is in our view quite obvious that the immediate recognition of all changes in the income statement does not necessarily reflect the true state of a benefit plan for an individual reporting period.

In **Preliminary View 3 (PV 3)** the Board proposed that entities should not divide the return on assets into expected return and actuarial gain or loss, partly because the Board considers the expected rate of return method to be too subjective.

Concerning this issue we do not agree with the Board. Although we share the view that the expected cash flow method is subjective, we would point out that management judgement is required in various other areas of accounting. Therefore we believe that auditors and regulators should examine whether a company sets the appropriate expected rate of return on plan assets. In our opinion sufficient objective evidence - as for example current and future expected asset allocation, long-term actual portfolio results and historical total market returns, estimations of banks and asset portfolio managers regarding future returns - is available to validate the appropriateness of expected return rates. Besides enhanced disclosure requirements, like for example the methods and supporting factors used in determining the expected return rate(s), a sensitivity analysis showing the effects of changes in the expected return rate(s) on total benefit cost or the direct comparison of expected and actual return rate(s) over a longer time horizon can provide investors and other users of financial statements with information necessary to assess the appropriateness of expected return rates.

The third Approach [presentation of changes in the amount of post-employment benefit costs other than those arising from changes in financial assumptions in profit or loss i.e. costs of service, interest cost and interest income] requires a methodology to determine actual interest income on plan assets. Concerning this matter we believe - as described below - that the disadvantages associated with the second [using dividends received on equity plan assets and interest earned on debt plan assets] and the third [using marked yields at the reporting date on high quality corporate bonds to input interest income] method by far outweigh the presumed weakness of the first method [using the expected return on plan assets, as currently required by IAS 19]. Therefore the first method is superior to the other methods.

The second and the third method of Approach 3 are not suitable for faithfully representing the actual economic situation of companies investing in plan assets.
The second method would not include (unrealised) capital gains or losses on equity securities. Besides, the fact that the DP does not regulate the treatment of realised capital gains and losses will probably result in different treatments for dividend-paying and non-dividend-paying equity investments. This method would potentially distort pension plan investment policies.
The third method might encourage companies to make more higher-risk investments as there is no downside risk with respect to future earnings. Unfortunately this aspect is not considered in the DP.

We agree with the Board's **Preliminary View 4 (PV 4)** regarding the recognition of the unvested past service cost in the period of a plan change but we nevertheless believe that there is a conceptual inconsistency with the relevant requirements set forth in IFRS 2.

Chapter 3: PRESENTATION APPROACHES FOR DEFINED BENEFIT PROMISES

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?

As mentioned in our Summary of Comments, we find it difficult to decide between the three presentation approaches as long as we have no further information regarding the future framework requirements for the presentation of financial statements. So far, if we had to choose between the three approaches presented in the DP, we think the third Approach in combination with calculating interest income by the expected return-method would be suitable.
We believe - as outlined in our answer to Question 2 - that gains or losses resulting from effects which are most likely to reverse over the period of the underlying obligation should not be allowed to affect the predictive quality of such key performance indicators as net profit or loss or earnings (losses) per share presented on the income statement. As predictive quality cannot be maintained without additional information about the impact of those income effects which reverse over the period of the

underlying obligation, we disagree with recognising all changes through profit or loss. Regarding the composition of post-employment benefit cost, decision-useful information comprises service cost and interest cost. However, information about the actual return on plan assets and the period's actuarial gains and losses resulting from the remeasurement of the benefit obligation and plan assets is not the main factor of interest with regard to a going concern assumption for the operating business.

Assuming that the disaggregated information would be presented in the notes to the financial statements, this approach would refer financial statement users to the notes, although the Board usually criticises such a pattern. Moreover, we presume that preparers and users of financial statements would make different adjustments to eliminate elements of pension cost with low predictive value. Those individual and therefore different adjustments would reduce the comparability of financial statements among different companies.

Since the exclusion of interest cost on the pension obligation and, if funded, the exclusion of the returns on plan assets from the income statement would ignore the economic differences between a funded and an unfunded pension obligation, we disagree with Approach 2. We strongly prefer Approach 3 as it focuses on information which is relevant for income from the operating business. In our opinion interest income on plan assets should - as explained in our answer to Question 2 - be determined by using the expected return-method.

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?

a) As an alternative interim solution we recommend the full recognition of actuarial gains and losses in OCI, which is already permitted under IAS 19. The currently existing alternatives should be disallowed.

b) We share the Board's reservations about changes in assumptions regarding service cost being recognised in OCI. However, the fact that this approach is very well accepted among preparers as well as users of financial statements and also easy to understand should also be taken into account. Considering that the alternative methods discussed in the DP seem arbitrary and flawed, the argument that the use of the expected return-method is too subjective is not convincing.
   In our opinion, the Board should limit its improvement activities during this first phase of the project to a consistent recognition of all actuarial gains and losses in the balance sheet while eliminating existing options regarding recognition in the income statement.

Chapter 5: DEFINITIONS

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 agree either with the Board's preliminary views concerning the new categorisation of post-employment benefit arrangements or with the new definition of "contribution-based promises" and the intended measurement at fair value. We are confident that the existing conceptually sound and readily understandable characterisation of post-employment benefit promises on the basis of the risk posed to the reporting entity clearly reflects the economic difference between the two types of promises and does not lead to any cases of doubt.

The definition of contribution-based promises is difficult to understand and lacks economic substance, although a simple procedure to assess whether benefit promises will impose ongoing risk to the reporting entity should be in the interest of all financial statement users. Moreover, the proposed new category of contribution-based promises includes promises, like for example career average plans that logically fit into the defined benefit category. Under the proposed rules they would be reclassified and therefore subject to different rules concerning measurement and presentation.

In contrast to the Board's preliminary view that the introduction of the new category would not result in a material reclassification of existing plans, this reclassification would in fact have a serious impact on accounting for post-employment benefits in our company. Applying the new categorization to Bayer Group pension plans as of December 31, 2007 more than 75 percent of the defined benefit obligation (about €11.6 billion) would have to be reclassified from a defined benefit to a contribution-based promise.

We have significant concerns with regard to measuring contribution-based promises at fair value for several reasons. First, in the case of post-employment benefit promises no active market exists from which reporting entities could easily derive objective fair values. Secondly, as currently discussed in the Fair Value Measurement Project, the fair value concept raises several questions, such as how to determine the fair value of post-employment benefits. On the one hand it could be based on the exit value, as pension obligations usually are not settled before retirement; on the other hand the fair value could imply the anticipated settlement at retirement. Furthermore, it has to be decided whether or not the fair value should include the profit margin and risk premium that a potential acquirer would be likely to charge. Besides, fair value measurement is to some extent arbitrary as the risk of a change in the terms of a benefit promise is excluded from the determination of the fair value. Alternative methods of deriving the fair value of a benefit promise would require broader disclosures, especially if the entity's own credit risk is to be considered, as they are more complicated and not standardised and would lack a certain degree of transparency.

Taking an entity's own credit risk into account is in itself highly questionable, because the worse the credit rating, the lower the obligation, whereas the amount which has to be settled at the maturity date is not affected by the credit rating. Moreover, it demands highly complex calculations (e.g. the consideration of partly insolvency-insured plans).

While for contribution-based promises an entity's own credit risk has to be considered, for defined benefit promises a different discount rate based on corporate bonds has to be applied. In our opinion the requirement to use a different discount rate for contribution-based promises and defined benefit promises is conceptually unconvincing, and we see hardly any economic reason that would justify different measurement attributes for these two types of benefit promises. This could also impair comparability among companies. Therefore we find the Board's PV concerning the measurement of the benefit promise in the deferment and payment phases according to the classification of the promise in the accumulation phase is also unconvincing because economically similar benefit promises could be measured differently in the deferment and payment phases depending on their initial classification for the accumulation phase.

Based on the arguments outlined in our answers to Questions 2 and 3, we agree with the Board that there are certain kinds of promises ("troublesome plans") that require short term improvements as regards accounting for post-employment benefits within the first phase of the project. However, we disagree with the immediate recognition of all fair value changes in the income statement.

In our opinion, the designation of plans as "troublesome plans" that might face measurement difficulties is primarily applicable to promises that depend upon, or are linked to, the return on an asset, a group of assets or an index. These "troublesome plans" should be measured at the fair value of the underlying or notional assets. Benefit

promises mentioned in Chapter 5 and Appendix A of the DP, including career average plans and promises with a fixed return, do not pose difficulties. Assuming that an entity has invested in plan assets to which the benefit promise is linked and has thus fully and effectively protected itself against changes in the defined benefit obligation, the liability and asset amounts would be equal comparable to IAS 19.104.
If a benefit promise contains a “higher of” option, such as for example a guaranteed minimum return of 3 percent p.a., the host benefit promise should be recognised as a regular defined benefit promise, i.e. by applying the PUC method or the method described in the preceding paragraph, whereas the option should be measured at fair value. The fair value should be determined by an appropriate option pricing method.

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?

As outlined in our answer to Question 5 the proposed classification of post-employment benefit promises would have a severe impact on the financial statements of our company. Examples of the practical difficulties the proposed changes would entail include the presentation of the specific risks associated with post-employment benefit obligations to the users of financial statements and the effects of the immediate recognition of the fair value changes in pension liabilities and plan assets in the income statement.

Question 7

Do the proposals achieve that goal? If not, why not?

Yes.

Chapter 6: RECOGNITION ISSUES RELATING TO CONTRIBUTION-BASED PROMISES

Question 8

Do you have any comments on those preliminary views? If so, what are they?

We generally disagree with the proposed definition of contribution-based promises. Consequently we have no further comments on PV 9 and PV 11. Moreover, we would like to point out that the implementation of PV 10 would lead to a further inconsistency in accounting between CB promises and similar DB promises.

Chapter 7: MEASUREMENT OF CONTRIBUTION-BASED PROMISES – CORE ISSUES

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?

(a) Please refer to our answer to Question 5.

(b) From a practical point of view we believe it would be difficult to include the effect of an individual promise's risk in the manner proposed and therefore we do not recommend implementing the proposed treatment during the first phase of the project. Besides, as outlined in our answer to Question 5, we are generally concerned about the requirement to consider an entity's own credit risk in determining the benefit obligation.

Chapter 8: MEASUREMENT OF BENEFITS AFTER THE ACCUMULATION PHASE

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 are not in line with the Board's PVs on a new definition of contribution-based promises or with the intention to change to fair value measurement, as we believe that economically similar benefit promises should be measured in the same way to assure comparability among companies (for further details refer to Question 5). Finally, as explained in our answer to Question 5, we recommend reducing the number of plans to which this short-term project relates by concentrating on "really" troublesome pension plans.

Chapter 9: 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?

We have no further comments.

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?

We have no further comments.

Chapter 10: 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?

We have no further comments.

OTHER MATTERS

Question 14

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

We would like to point out that disclosures regarding post-employment benefit obligations are already extensive. Therefore the costs of possible further requirements should be carefully balanced against the information content of the potential additional disclosures.

Question 15

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

We have no further comments.