12 May 2008

Project Managers
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

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

Dear Project Managers,

We appreciate the opportunity to comment on the International Accounting Standards Board's ("IASB" or "Board") Discussion Paper on Preliminary Views on Amendments to IAS 19 Employee Benefits (the "Discussion Paper").

Fitch, and the role of pensions in its analysis

Fitch Ratings (Fitch) is a leading global rating agency committed to providing the world's credit markets with independent, timely and prospective credit opinions. Fitch's corporate finance ratings make use of both qualitative and quantitative analyses to assess the business and financial risks of fixed-income issuers. Therefore, Fitch directly relies on the financial statements and that reliance places us in an informed position to comment on information we believe is useful and crucial in the credit evaluation process, which is a critical component of efficient capital markets.

Fitch's key use for pensions accounting and disclosures is in assisting us to determine how an entity's pension commitments affects its ability to service its debts as they fall due.

Across its corporate work Fitch recognises that pensions have some elements which are similar in nature to a debt obligation, but some significant differences. Fitch therefore includes reported pension deficits in certain of its key analytical metrics.

In rating corporates, our analysis also includes forming a view on the drain on operational cash flow which an entity's pension promises represent. Rating analysis of financial institutions includes an assessment of whether the pension liabilities figure needs to be adjusted in our calculation of loss-absorbing capital for unexpected risks. Information on actual and expected near-term cash outflow relating to pensions is an important consideration in credit analysis. Therefore, disclosure of regulatory requirements is particularly helpful.

To a lesser extent the agency uses the data to determine the potential impact of a pension scheme on other classes of creditor in the event of a winding up or financial restructuring. As the liability any scheme represents on a winding up is typically based on regulatory, rather than accounting, measures, the disclosures of regulatory measures of a scheme's deficit are again helpful to analysis.

Overall requirements

Fitch supports the Board's approach to confine its amendments to the most pressing issues which have been brought to light as a result of market comment. Fitch believes there are significant ways in which the current standard could be improved with only minor changes.

While there may be reasons for change in the basic framework of pensions accounting, these should be considered in the light of the convergence project with the US Financial Accounting Standards Board (FASB) and once the outcome of certain of the IASB's other key projects, such as financial statement presentation, fair value accounting and phase II of accounting for insurance contracts are complete or substantially progressed.

There is considerable value, in the meantime, of keeping the basic framework, with which users and preparers are now familiar, in place. However, Fitch does consider that certain changes would improve the value of pensions accounting easily and without altering the basic framework.

There are a number of key requirements of pension accounting and disclosure if it is to be of use to us in our work. Current disclosure requirements address all of these issues to an extent, and Fitch would like to see current practice maintained, if not improved upon, in respect of the following points:

1. Transparency, including the clear separation of pension-related items from other items. The operational characteristics and risk profiles of the core business of most of the entities Fitch rates vary considerably from those associated with a pension scheme. It is therefore important to be able to understand what pension accounting entries have been applied, so that we can adjust for them if necessary.

2. Consistency of accounting treatment - this includes a limitation of the number of options available to entities when accounting for pensions, which should aid comparability between entities. Key improvements on current standards include:

    a. an elimination of the option to use the corridor approach; and

    b. a requirement to show pension-related items in a consistent category (or categories) in the statement of financial performance (for example, avoiding the choice entities currently have to show the financing components of pensions within operating profit or as a financial item).

3. Consistency of computation - as little choice between companies of actuarial and other assumptions as is practical, and where a choice must be available, comprehensive disclosure of the choices made allowing comparability between companies. Fitch recognises that it is appropriate and desirable for an entity to be able to select certain assumptions, such as mortality, to reflect the characteristics of its workforce and pension arrangements. On the other hand, one of the key strengths of IAS 19 is its relatively prescriptive requirements in respect of interest rates. Were this to be replaced, Fitch would welcome a similarly restrictive approach.

    Fitch has found the disclosure required by the UK Accounting Standards Board (ASB) of mortality assumptions and the sensitivity of pensions related items to variations in assumptions to be very useful and would encourage the IASB to adopt similar disclosure requirements so that we can see this in a wider group of companies.

4. Disclosure of current, comparative and agreed future cash contributions to pension schemes, and an indication of the regulatory environments governing cash contributions in each of an entity's key jurisdictions. This should include, where possible, disclosures of regulatory measures of the pension deficit, and the key assumptions included in this calculation.

Fitch would be concerned with any changes to the current accounting framework which result in pension deficits being grossly different to regulatory bases. Pension obligations, no matter how measured, remain highly uncertain. A regulatory measure gives an indication of the actual cash commitment needed by the entity in the medium-term (say five years), a period over which there is some certainty. This more reliable measure provides the type of information that best meets the aim of the Board identified in paragraphs IN11 and 1.24 of the Discussion Paper, which state that "the Board will pay particular attention to the need for users of financial statements to receive relevant and reliable information for assessing the amount, **timing** and uncertainty of an entity's future cash flows."

Specific Questions

Fitch's responses to the questions posed below are based on the fundamental requirements we have in order to be able to perform our work as credit analysts as outlined above.

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?

A1. There are some items of note which Fitch would like to see addressed as a matter of urgency that are not addressed by the IASB's paper. These are as follows:

- The introduction of specific additional disclosures, in line with the ASB's January 2008 Discussion Paper "The Financial Reporting of Pensions" surrounding mortality assumptions and the sensitivity of calculations to changes in assumptions. These sensitivities should include the impact of changes is mortality assumptions.

- Changes which ensure that any income statement items are consistently classified. The current situation where companies have a choice of line item in which to disclose interest cost and expected return on assets give rise to inconsistencies when comparing companies with different treatments.

- Consideration of how reconciliation can best be made between what is reported in the income statement and in the cash flow statement concerning pensions. This is a factor the Board will need to consider as part of its project on the presentation of financial statements, where we understand that one of the main objectives to date has been to achieve cohesiveness between the various financial statements – an objective Fitch strongly supports.

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?

A2. Fitch agrees with the Board's preliminary views in this matter, for the reasons set out above.

The only additional factor to those highlighted in our answer to question 1 that the Board should consider is the potential impact of immediate recognition of actuarial gains and losses on companies' ability to pay dividends, due to legal restrictions based on balance sheet, retained earnings or income statement values. While Fitch notes this is ultimately a matter for the regulatory authorities concerned, Fitch would urge the IASB to give explicit consideration to this point in its final decisions.

Fitch also notes the potential difficulties that the additional income statement volatility poses to financial covenants based on earnings or net assets. Clear and consistent disclosure of pensions related items would allow these items to be adjusted for in whatever way lenders and borrowers can agree is appropriate.

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?

A3 a) For Fitch's purposes, there is little to choose between the three approaches set out, though approach 1, which recognises all gains and losses through the income statement is the most simple and transparent, and therefore the most desirable. Ideally service cost items, which would be expected to be recurring and essentially arise from the current year's trading, should be included when arriving at operating profit. Other items, which are largely the result of changes to previously accumulated assets and liabilities ('financing components', as described in the discussion paper), should be shown below operating profit. This presentation also addresses to an extent the volatility argument – entities would be able to present a relatively stable pension cost in operating profit and reflect other costs below this line.

With respect to approach 3, Fitch sees no value in replacing expected return on plan assets with another arbitrary measure described as interest income on plan assets. Approach 3 would seem to introduce rather than eliminate complexity – and is therefore the least desirable of the options. If this approach were taken then retaining the concept of expected return on plan assets, which is understood and relatively transparent (due to disclosure of expected rates of return) would seem the most appropriate way to estimate 'interest income.'

As noted above one of the key considerations for the agency is ensuring that whatever is presented is presented consistently across companies, and that the different pension-related items can be extracted from the income statement as required and reconciled to real cash flows.

A3 b) As discussed above, in evaluating the strength of an entity's core business, Fitch values the inclusion of service cost when arriving at operating profit. Arguments for putting some changes through other comprehensive income generally centre around smoothing income statement movements, and Fitch sees limited justification for not including these in the income statement, so long as they are properly disclosed. Users can then decide whether to remove them or not.

Fitch recognises, however, that this change could have serious repercussions on asset allocation (with entities shifting allocations to low volatility assets) at the expense of long-term return. This would require companies to invest more cash in their pension schemes than may otherwise have been the case. Fitch urges the IASB to consult closely with representatives from pension scheme providers to understand the wider repercussions of any changes.

Fitch's analysis and users' understanding would be aided by a consistent presentation of whatever items are classified as profit and loss items. Entities should not be given a choice (as suggested by paragraph 3.25 of the Discussion Paper) over whether to include financing components in the operating or financial sections of the income statement. Fitch views this as one of the key practical difficulties encountered when comparing companies reporting under current IAS 19.

As noted in Fitch's response to Proposed FASB Staff Position No. FSP 132(R)-a, "Employers' Disclosures about Postretirement Benefit Plan Assets" available at www.fitchratings.com, Fitch is very supportive of the efforts which improve disclosures about post retirement plan assets, and their method of valuation. The proliferation of investment alternatives available to pension plans and the inherent market and liquidity risks of relatively new complex investments make it important to require more extensive disclosure surrounding the types of assets held in pension plans.

A3 c) See answer to question A2.

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?

A4 – See answers to questions A1, A3 a) and A3 b).

Questions 5 - 14

Fitch is not involved in the detail of designing and accounting for pension benefits. Other than welcoming changes that cause plans with some of the characteristics of defined benefit plans which may have not been recognised as liabilities to be recognised, Fitch has no detailed comments on the contribution-based promises sections of the proposals.

Question 15
Do you have any other comments on this paper? If so, what are they?

No further comments.

FitchRatings
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We would be happy to answer any questions on our comments.

Yours faithfully,

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