The IASB's Preliminary Views on Amendments to IAS 19 Employee Benefits

This paper sets out the views of Abelica Global on the IASB's discussion paper on IAS 19 Employee Benefits, dated March 2008.

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Summary
In our view, it is a difficult time for the IASB to undertake a review of accounting for employee benefits, when there are two IASB projects, on Financial Statement Presentation and Fair Value Measurement, which are not complete but which have a fundamental effect on the IASB's proposals in relation to IAS19.

In relation to the presentation of IAS19 results, we agree that delayed recognition of gains and losses results in confusing balance sheet figures, and that immediate recognition is preferable. But we believe that it is inappropriate to recognize all gains and losses in profit and loss, as the resulting profits and losses will be volatile even there is no short or medium term effect on the company's cash obligations to the benefit plan. We are concerned that, if this approach is adopted, pension figures will simply be stripped out of profit figures by analysts keen to understand the nature of the underlying company business.

Our preferred approach to reporting pension cost is under an adapted version of Approach 3. We believe that the effect of **all** remeasurement (ie changes in actuarial projection assumptions) should be recognized in other comprehensive income. On the asset side, we prefer to retain the split of investment return into expected return and gains and loss, recognized in profit & loss and other comprehensive income respectively, on the grounds that neither of the other two approaches have any economic predictive value.

We believe that, in setting the definition of contribution-based promises, the IASB has grouped together a set of benefit plan designs that do not have a common economic basis. The IASB has not made the case for an accounting treatment of these plans which differs so significantly from the treatment of defined benefit plans. For pensions that are in payment, the IASB's proposed accounting treatment for an obligation to pay £100 a year of pension differs, depending on whether the pension derives from a defined benefit plan or a contribution based promise. However the company's pension obligation is exactly the same in both cases, and we believe that they should be measured at the same value.

With, we understand, still some way to go in the IASB's project to determine a definition of fair value, and with no detailed guidance as to how fair value should be defined for pension

obligations, our view is that changing IAS19 so that contribution-based promises are measured at fair value is at best confusing and we recommend that no change is made for now.

If the IASB wishes to introduce fair value as a measure of a pension obligation, we strongly recommend that it undertakes more detailed research and consultation on this, before incorporating a fair value measure for pension obligations into IAS19. Pension obligations are among the longest term obligations that a company may have. As such, they are among the most susceptible to small changes in valuation assumptions. For this reason, if fair value is to be used as a measure for pensions, it is important that IASB work on fair value includes a close review of the effect of any of its proposals on pensions.

Detailed comments

Our detailed comments on the discussion paper are as follows.

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, in our view other issues should be dealt with in the IASB's longer term project

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?

In our view, a fundamental requirement of IAS19 is that, where employee benefit plans provide the same benefits as one another with the same underlying risk factors, they should be brought into account in the same way as one another. Unfortunately, we do not think that the proposals in relation to contribution-based promises achieve this, with a pension that is in course of payment being valued in a different way, depending on whether the pension arose from a defined-benefit promise or a contribution-based promise during its accumulation phase.

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?

An adaptation of Approach 3 is our favoured approach.

Approach 1 would result in a far more volatile profit figure for the company, with market movements resulting in volatile earnings where there is not necessarily going to be a significant effect on the company's cashflow in the short to medium term. If Approach 1 is adopted, we believe that financial analysts will strip pension information out of company profits for their analyses. We understand that analysts treat the components of pension cost that arise from gains and losses as a far less important predictor of future company earnings than the components such as service cost. We may find that analysts adapt the current EBITDA measure so that it becomes EBITDAP – earnings before interest, tax, depreciation, amortisation and pensions – stripping out any useful pension information. Consequently, our view is that aggregation in this way is not decision useful.

Approach 2 is preferable to Approach 1, because the method separates out the noise of some measurement changes from the "normal" cost of benefits. However, we prefer an adaptation of Approach 3, which clearly separates the costs of benefits earned by members / granted by management during the year, together with the "normal" unwinding of the discount and changes in asset values with the passage of time, from the effects of remeasurement. We believe that this approach is more decision useful than the others.

We suggest that Approach 3 is adapted so that all remeasurement assumptions, not just discount rate changes, are recognized in other comprehensive income. The separation of changes in discount rate from other changes in actuarial assumptions is an artificial one. For example, the change in the projected future rate of inflation is an assumption that will typically reflect market yields, particularly the real yield on index-linked bonds, where these exist. Indeed, a plan that provides index-linked benefits may find little change in its overall obligation where a 1% rise in bond yields occurs at the same time as a 1% rise in market-predicted inflation rates, and indeed economically, the plan is in much the same position after the change. But the change in inflation assumption will result in an increase in the obligation which will be recognized in income, where the equal reduction in obligation arising from the discount rate change will be recognized in other comprehensive income.

In our view, the IASB's concerns over the use of an expected return on assets are unfounded. We acknowledge that the measure is somewhat subjective for asset classes such as equities, but such uncertainty is inherent in estimates included in other items in a company's accounts. There are reasonably well-established approaches to calculating an expected return on assets, and financial commentators who draw attention to the use of assumptions that are outside the norm. Indeed, it is very easy for an accounts user who wishes to adjust the expected return to reflect different return assumptions.

Our preference therefore is to use Approach 3, retaining the expected return on asset approach that has been used historically, and adjusted to include the effect of all remeasurement changes in other comprehensive income, not just the discount rate. The IASB may wish to develop further guidance on setting an expected return assumption.

In our view it would be inappropriate for the amount of return recognized in income to be the amount of dividend or interest income, on the grounds that this would encourage management to favour scheme assets that produce income over those that produce capital growth.

We are not in favour of setting a credit to profit calculated by multiplying the discount rate by the fair value of assets (with appropriate adjustments for plan cashflow during the year). The figure has no economic meaning in the context of an investment portfolio that does not typically focus on corporate bonds. However, if the IASB does not accept that the expected return approach should be retained, we would prefer this approach over one based on dividend or interest income, on the grounds that the calculation is easy to understand, and analysts can easily substitute their own assessment of expected return if they wish. On this basis, information should also continue to be provided about the nature and split of the scheme assets held, to permit analysts to undertake their own assessment of investment returns.

Finally in this section, we believe that it is important that an asset return figure is included in the same part of the financial statements as the interest cost. If for example the interest cost were to be recognized in profit and loss and the expected return in other comprehensive income, this would falsely enhance the profits of a company which had chosen not to pre-fund pensions and retained funds to earn profits in the business, over the profits of a company which had pre-funded pensions.

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?

We have no further suggestions.

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?

Unfortunately, we believe that the Board has extended the scope of its project far beyond what was justified by the perceived "problems" with the existing arrangements. There is no special common feature of contribution-based promises that justifies changing the projected unit credit method valuation that has been applied successfully for many years for defined benefit promises.

In our view, the majority of "contribution-based" plan designs are most like the defined benefit plans that are valued using the projected unit credit method. This is because they expose the employer, to a greater or lesser extent, to risks that are not fully hedged by holding fully matching assets.

This position may change gradually with developments in derivatives markets, for example if a liquid market in mortality hedging products develops. But for the time being, there is no established market which can be used as a reliable basis for developing fair value measures, and indeed it appears to us that the accounting profession is some way from developing a consensus approach to setting fair value. This is particularly important for pensions, where liabilities are typically long term, a "fair value" can vary significantly with a change of a few basis points in discount rates or other valuation assumptions, and the measurement typically involves features, such as mortality, where there are no markets that may help to establish fair value.

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?

All promises other than those given by final salary or final average salary plans would be reclassified as contribution-based. In fact, if a final salary plan were closed to future accrual, so that benefits were either pensions in payment or terminated vested pensions that were no longer linked to salary, even this would meet the contribution-based definition.

The changes would affect career average salary plans, which are prevalent in the Netherlands and becoming so in the UK, and fixed dollar plans which are common in the United States.

The major problem with this is that a group of very different types of benefit promise have been lumped together, because they are or can be restated in a way that is deemed to be equivalent to a promise based on contributions. There is no rational economic reasoning put forward in the paper that explains why these promises are economically similar to one another or different from defined benefit plans, and so why it becomes appropriate to move away from the projected unit credit method of valuation.

We are concerned that companies will have to commission a whole new set of calculations, on a basis which is not currently well understood by pensions professionals (or, for that matter, many accounting professionals), which could be completely overturned by the IASB once it undertakes its phase 2 major review of IAS19 or reaches a set of conclusions on fair value.

We understand that there are many items on a company's balance sheet which are not currently stated at fair value. We do not believe that it is appropriate to experiment with one area, pensions accounting, in these circumstances.

Question 7

Do the proposals achieve that goal [that the accounting for plans currently treated as defined contribution will not change much]? If not, why not?

The goal is achieved, which is the one redeeming feature of the proposed approach. By definition, the assets and liabilities of a defined contribution plan match one another, so the only cost in any year is the contributions due to the plan during that period. This would be the same under the proposed accounting for contribution-based promises.

Question 8

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

We agree with these preliminary views. In particular, we believe that, while the reporting entity is a going concern, it would be inappropriate to allow for extra liabilities that could arise if the plan members were to leave employment immediately after the reporting date. The exception to this is where a significant part of the workforce is to be terminated, but this is already handled by the existing IAS19 rules on curtailments.

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?

In our view, a case has not yet been made for changing the valuation method that is applied to contribution-based promises. The features of contribution-based promises are similar to those of defined benefit promises, namely risk (economic, demographic) that cannot easily be hedged or for which there is an obvious way of determining "fair value". For this reason, we recommend that the IASB drops its attempt to devise a new method for contribution-based promises, and picks up the issue in its Phase 2 project.

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 not agree that this is an appropriate requirement for benefits in the payout and deferment phases to be measured in the same way as they are in the accumulation phase. We believe that if a company has responsibility for a pension in payment of 100 a year, its measured obligation should be the same, whether the pension was derived from a defined benefit or a contribution based promise. The two types of obligation are economically identical, and it makes no sense to measure them differently. (Note that, where the pension has been fully secured with an annuity, the method of measurement is less important, as the plan will always have fully matched assets and liabilities in relation to the promise. But the principle needs to be agreed for those cases where the benefit is not secured.)

In the absence of changes to the measurement of defined benefit obligations for IAS19, we believe that defined benefit valuation techniques should be used for the valuation of pensions in the payout phase, and that this is readily understood and causes no implementation problems.

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?

Our suggested approach for most contribution-based promises is to retain defined benefit valuation techniques, and this extends to the disaggregation of information required for financial statements.

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 suggest the same recognition as for defined benefit schemes ie the split using a modified version of approach 3, as described in our response to question 3.

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 recommend that, if a plan with a "higher of" option is in substance a defined contribution plan, with the other benefit option applying infrequently, it should be permissible to start from the investment-based value, and to add the value of the "higher of" option. In many cases, we expect that the value of the option will be immaterial.

It is quite common for "better of" options typically to favour one or other of the options. For example, Belgian plans will typically result in members receiving a benefit of plan contributions plus actual investment returns on the contributions, although if the total contributions plus interest at a fixed minimum rate results in a higher figure, this figure will be paid. The minimum rarely applies because plan assets are typically invested in bonds which have a relatively stable positive return, and because the minimum interest rate is applied as a check only of the total accumulated amount at retirement, rather than being applied to each year's investment return in isolation.

In this situation, it is clear that any fair value measurement will not be significantly higher than the underlying fair value of the defined contribution promise. If the value is measured using defined benefit techniques for the defined benefit underpin, plus the fair value of the top-up, it is quite likely that the resulting value will be nowhere near the fair value of the defined contribution promise. This is an undesirable feature for a plan that predominantly provides defined contribution benefits. It should be a matter of judgement for the preparer of financial reports to judge which type of promise is the predominant one, and hence which method of measurement is appropriate, provided that a consistent approach is used from year to year. Indeed, if the effect of a top-up is immaterial, it should be permissible to place a zero value on it.

Question 14
What disclosures should the Board consider as part of that review [an IASB review of the disclosures required about post-employment benefit promises]?

The IASB should ensure that there is adequate information disclosed for the user to have an understanding of the major assumptions underlying the measurement of benefit obligations, and the sensitivity to changes in those assumptions. The main item that is not always disclosed is, as the paper suggests, information about members' life expectancy for a benefit plan that provides pensions for life.

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

We would be interested to learn how the Employee Benefits Working Group contributed to the paper. Our impression from the activity recorded on the IASB website is that there were no meetings of substance of the Group before publication of the Discussion Paper. We have pointed out above our concerns about the breadth of the scope of contribution-based promises and the consequential difficulties in implementing the recommendations of the Discussion Paper. We would have hoped that a group of employee benefit experts would have drawn the IASB's attention to this at an earlier stage.

If you have any questions on this response, please contact Charles Young at our UK member firm, Hymans Robertson (telephone +44 20 7082 6228, or email charles.young@hymans.co.uk).