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Our ref MT/288
Contact Mary Tokar

10 September, 2008

Dear Ms McGeachin:

Comment letter on Discussion Paper, *Preliminary Views on Amendments to IAS 19 Employee Benefits*

We appreciate the opportunity to comment on the Discussion Paper, *Preliminary Views on Amendments to IAS 19 Employee Benefits* (DP). This letter expresses the views of the international network of KPMG member firms.

We support the Board's objective of improving the accounting for post-employment benefits; however, we question the scope of the short-term portion of the post-employment benefits promises project and therefore the scope of the DP. In general, the proposals, particularly the proposed distinction between defined benefit and contribution-based promises and the introduction of fair value measurement for contribution-based promises, appear to be a fundamental reconsideration of the principles of current IAS 19 *Employee Benefits*; and we believe that a fundamental reconsideration is not appropriate for a short-term project.

While we appreciate the Board's attempt to address types of plans that cause financial reporting difficulties in practice, such as cash balance plans, we are concerned that the definition in the DP of a "contribution-based promise" is too broad, and would result in a significant number of plans that currently are classified as defined benefit plans being classified as contribution-based promises. As a result, we expect that a number of plans would be subject to fundamentally different accounting requirements under the DP than currently required, by being classified as contribution-based promises.

In addition, while we do not necessarily object to the model being proposed in the DP for contribution-based promises as a more faithful measurement of the sponsor's obligation, the Board has not explained why this model is more faithful only for this category of promises and not also for other promises, e.g. defined benefit. We are concerned with the piecemeal approach that is the consequence of this short-term project introducing a very different model for a category of post-employment benefits. We believe that the Board's and its constituents' time would be better spent by accelerating the long-term portion of the project and limiting the short-term project.

As such, we would prefer that the Board either limit the scope of the short-term project to removing the current smoothing mechanisms (the "corridor") or abandon the notion of a short-term project and pursue a comprehensive project that would include a full reconsideration of IAS 19. Alternatively we would not object if the IASB, as its scope for the short-term project, proposed to remove the current smoothing mechanisms and also proposed to address very specific types of cash balance plans without a broad definition for "contribution-based promises". While this approach would be more in line with what we believe would constitute a short-term project, we recognise that it might be criticised as not being principles based.

Lastly, we would like to highlight our concern regarding the interaction of this project with the IASB's financial statement presentation project. As noted in our responses to Questions 3 and 4, until the IASB finalises its financial statement presentation project, any conclusion that the Board reaches on the presentation of defined benefit promises may be premature. We believe that the principles underlying the presentation of employee benefit costs should be consistent with all other aspects of financial statement presentation for other accounting matters.

Our responses to the questions asked in the paper are set out below.

Question 1 - Scope

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?

In light of our overall comment with respect to the scope of the short-term project, there are no additional matters that we believe should be addressed. Rather, we believe that the scope should be narrowed or the idea of a short-term project abandoned.

Question 2 – Recognition of defined benefit promises

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?

We support the DP's 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 optional "corridor" deferral method for actuarial gains and losses.

We also agree with the DP's proposal to recognise unvested past service cost in the period of a plan amendment. As a related comment, however, we believe that it would be useful if the basis for conclusion addressed the underlying principle supporting why immediate recognition is appropriate.

We also support the DP's proposal to remove the concept of "expected return on plan assets" as it does not result from an actual transaction for the period and therefore is difficult to justify recognising separately from the actual return on assets. However, we note that this proposal is inconsistent with the proposed presentation alternatives for defined benefit promises that sub-divide the return on assets into an expected return and an actuarial gain or loss. We recommend that this inconsistency be eliminated. See further commentary on this topic in our response to Question 3.

Question 3 – Presentation of defined benefit promises

(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?

In our view, until the IASB finalises its financial statement presentation project, any conclusion that the Board reaches on this area may be premature, on the basis that the principles underlying the presentation of employee benefit costs should be consistent with all other aspects of financial statement presentation for other accounting matters. Our comments with respect to this question therefore are made subject to the progress on the financial statement presentation project and consistency with any overall principles defined under that project.

Of the three alternatives presented for defined benefit promises presentation we favour Approach 1 supporting the recognition of all gains and losses in profit or loss; this is due to the simplicity of Approach 1 as it will increase comparability amongst constituents and because all types of actuarial gains or losses might be perceived as being revisions to the estimate of the original cost for a period. We also see merit in Approach 3, whereby remeasurements arising from changes in financial assumptions are recognised in other comprehensive income (OCI) and all other changes are recognised in profit or loss; we do not see equal merit in Approach 2, whereby only service costs are recognised in profit or loss and all other changes are recognised in OCI.

Of the three options under Approach 3 for determining how to identify interest income on plan assets, we prefer the third proposed option to use market yields at the reporting date on high quality corporate bonds to impute interest income, since it might be seen as best reflecting that the entity only has an obligation when there is a deficit (and only potentially an asset when there is a surplus), with respect to its defined benefit promises. As a related comment, however, we recommend that the Board provide additional clarification on what is meant by “interest income”, e.g., whether it intends to have the same rate used on assets as is used to discount the liability.

While we see merit in Approach 3, we disagree with the proposals to present gains and losses on settlements in OCI, which is proposed in both Approaches 2 and 3. Paragraph 3.15 of the DP states that, for Approach 3, entities would present changes in the amount of post-employment benefit cost other than those arising from changes in financial assumptions (e.g., the costs of service, interest cost and interest income) in profit or loss. We note that gains or losses on settlements have multiple components that are not limited to changes in financial assumptions but also may incorporate changes in other non-financial assumptions; the settlement might be on terms other than those previously reflected in the accounting.

We recommend that the Board, if it proceeds with either Approach 2 or 3, further consider whether it is appropriate for gains and losses on settlements to be presented in OCI. In addition, we believe that it would be important to consider whether it is appropriate to treat curtailments and settlements differently, in light of the fact that settlements and curtailments often occur together, and therefore, it might be difficult to distinguish amounts that would be recognised in OCI versus profit or loss in these circumstances.

Question 4 - Presentation of defined benefit promises

(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?

As noted in our response to Question 3 above, until the IASB finalises its financial statement presentation project, any conclusion that the Board reaches on this area will be premature, on the basis that the principles underlying the presentation of employee benefit costs should be consistent with all other aspects of financial statement presentation for other accounting matters.

Question 5 – Definition of contribution-based promises

Do you agree that the Board has identified the appropriate [contribution-based] 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?

As stated in our overall comments, we believe that the proposed categorisation of benefit promises (defined benefit vs. contribution-based promises) appears to be a fundamental reconsideration of the principles of current IAS 19. As expressed previously, we are concerned that the definition of a "contribution-based promise" in the DP is too broad, and would result in a significant number of plans currently classified as defined benefit plans, in which the employer continues to bear demographic risk, being classified as contribution-based promises. See further discussion on this topic in our response to Question 6. We recognise that limiting the definition of a "contribution-based promise" to a more narrow definition would result in a limited number of promises being addressed by the proposals; however, we would find this to be a natural consequence of a short-term project that should not fundamentally change the principles of current IAS 19.

In addition, we recognise that it may be difficult to find a conceptual basis for distinguishing defined benefit promises from other promises, particularly those involving a guaranteed minimum return, even when determining a more narrow definition for "contribution-based promises". We believe, however, that the current IAS 19 boundaries between defined contribution and defined benefit plans, which are defined based on the risk to the employer, generally are clear and should not be altered in the short-term project. For example, in the DP proposals, plans in which significant demographic risk remains with the employer might fall into the contribution-based promise category. This shift of such plans to the contribution-based promise category would represent a fundamental change in the principles of current IAS 19, whereby demographic risk has been a determining factor for defined benefit accounting. As a result, we believe that, at a minimum, plans with significant demographic risk to the employer should remain within the defined benefit promises category, when considering how to narrow the scope of the definition for "contribution-based promises"; otherwise we believe that the end result would be a fundamental change in the principles of current IAS 19.

Question 6 – Definition of contribution-based promises

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?

Generally, we believe that a substantial number of promises would be reclassified from defined benefit to contribution-based under the DP proposals, as noted in our response to Question 5. We understand that some jurisdictions might be impacted more than others depending on the predominant types of plans in each jurisdiction. Other than the intended shift of cash balance plans from the defined benefit to contribution-based classification, we also note a shift in the classification of career average plans as a result of the DP proposals.

With regards to practical difficulties in applying the DP definitions of defined benefit and contribution-based promises, we believe that there are a number of application issues that might result. A few examples are as follows:

- In certain jurisdictions in recent years it has been common for an entity to change from having a final salary to a career average plan for its employees. This change is expected by the entity to result in cost reductions, as career average plan benefits are based on the employees' salaries averaged over a career, rather than on employees' salaries at the end of service for final salary plans when salary generally is expected to be highest. However, if the benefit is promised by an entity with a good credit rating and backed by a well-funded plan, then it is possible that in certain jurisdictions, depending on the underlying funding arrangements, the application of the contribution-based promise accounting proposed in the DP would result in the fair value of the career average pension obligation being higher than the obligation that was recognised previously for the final salary plan. We believe that an employer switch in plans that results in a benefit reduction to the employees could have an unusual consequence of an increase in the balance sheet liability due to there being two different measurement models proposed in the DP. We believe that this is not the intended outcome of the DP proposals and it highlights the inconsistencies that might result from having two different measurement models.

- While it is clear from the proposals in the DP that career average plans would be scoped into the contribution-based category, there is no proposed guidance on how to distinguish a career average plan from a final salary plan when the benefit promise under the final salary plan is calculated based on the average of the last few years' salary. Would a plan with benefits based on the average of the last 10 years of salary be a final salary plan, and therefore considered a defined benefit promise, or a career average plan, and therefore considered a contribution-based promise, under the DP proposals? What would be the answer if the benefit promise is based on the average salary for the 5 final years of service? Would the answer be different if statistics reveal that the entity's employees stay employed with the entity typically for 6 years or 30 years? We note that while the DP does propose in paragraph 5.40 that a benefit promise still would be considered within the scope of a defined benefit promise when the benefit promise is based on the average of salary for the 3 final years of service, we believe that constituents still will have application issues in determining whether final salary plans have benefit promises that are defined benefit or contribution-based promises as there is no clear principle articulated in the DP as the basis for having different accounting models.

- In certain jurisdictions in recent years some defined benefit plans under existing IAS 19 have closed to future accrual, so such plans would no longer have an accumulation phase. The DP proposals distinguish contribution-based promises from defined benefit promises by reference to the accumulation phase. In light of the proposals, constituents might believe that such plans still should be accounted for as defined benefit promises continuing with the defined benefit plan accounting under current IAS 19, while others might believe that these now meet the definition of contribution-based promises. Application issues might arise depending on whether constituents believe that the benefit promise would be classified based on how it was promised to the employee in the past or based on the current obligation. We note that Chapter 8 of the DP discusses this issue, in that a promise either is treated consistently throughout its life, i.e., measured in the same way from accumulation to deferment to payment, or would need to be measured differently post-accumulation phase so that economically identical liabilities post-accumulation phase are measured in the same manner. However, Chapter 8 does not address this particular transition situation. Therefore we suggest that if the Board retains the proposals in the DP, then the amended standard contain a clear statement regarding such transition situations. Also see our response to question 10.

Question 7 – Definition of contribution-based promises

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

We believe that the DP proposals would not change the accounting for most traditional defined contribution plans. However, as stated in our overall comments, we believe that the proposed categorisation of benefit promises (defined benefit vs. contribution-based promises) appears to be a fundamental reconsideration of the principles of current IAS 19 and a fundamental reconsideration is not appropriate for a short-term project.

Question 8 – Recognition issues related to contribution-based promises

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?

As stated in our overall comments, we believe that the proposed categorisation of benefit promises (defined benefit vs. contribution-based promises) appears to be a fundamental reconsideration of the principles of current IAS 19 and a fundamental reconsideration is not appropriate for a short-term project. However, we agree with the following preliminary views on how to recognise contribution-based promises, noting that they broadly are consistent with current IAS 19 and therefore would not result in a fundamental change to the accounting for most traditional defined contribution plans under current IAS 19:

- 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 for the additional amount determined by the benefit that an employer would pay when an employee leaves employment immediately after the reporting date.

Question 9 – Measurement of contribution-based promises

(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 general, we are concerned with the DP proposal to measure at fair value benefit promises that meet the definition of contribution-based promises. Due to the number of promises that we believe would meet the definition of contribution-based promises in the DP, we view this as a major change for most constituents and a fundamental reconsideration of the principles of current IAS 19. In addition, even if we believed that it was appropriate to do so, we believe that it would be premature to introduce fair value measurement for a certain category of promises, while other promises which might be similar economically (e.g., career average plans compared to final salary plans with benefit promises based on the last 10 years' service) still being measured using the projected unit credit method.

Even if the Board were to narrow the definition of contribution-based promises, we still would have some fundamental concerns over how to measure such promises at fair value. We believe that it is critical that if the Board proceeds with a fair value measurement approach for benefit promises, then the Board include additional guidance on the application of such approach. In particular constituents would need more information on how to incorporate demographic risk into the fair value measurement; we believe that this additional guidance should be derived from discussions with experts in the valuation of defined benefit plans.

The Board is proposing to incorporate credit risk, being the risk of non-payment of a benefit and not just the entity's own insolvency risk derived from its credit rating, into the fair value measurement of contribution-based promises. Even if we believed that it was appropriate to require credit risk to be taken into account in such measurements, we believe that this would introduce an unjustifiable difference within IAS 19 between accounting for defined benefit promises, discounted at the rate on high quality corporate bonds, and contribution-based promises, discounted at another rate, ahead of development by the IASB of any general requirement to reflect own credit risk across all similar arrangements, e.g., insurance contracts. We believe that such a difference would result in both inconsistency and reduced comparability.

Question 10 – Measurement of contribution-based promises

(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?

As stated in our overall comments, we believe that the proposed categorisation of benefit promises (defined benefit vs. contribution-based promises) and the proposed measurement approach for contribution-based promises appear to be a fundamental reconsideration of the principles of current IAS 19 and a fundamental reconsideration is not appropriate for a short-term project. As such, we do not support the DP proposal 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, as this would support the overall DP proposal to have a very different model for one category of post-employment benefits.

However, if the Board retains the proposed categorisation of benefit promises in the DP, then we would prefer a measurement discontinuity so that similar underlying liabilities are measured the same way in the post-accumulation phase.

Question 11 – Disaggregation, presentation and disclosure of contribution-based promises

(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 disagree with the DP proposal that changes in a liability for a contribution-based promise should be disaggregated only into a service cost and other value changes. While it might be difficult, we believe that entities should be required to disaggregate changes in a contribution-based promise liability according to the same principles as IAS 19 (as amended) would require for defined benefit promises.

Question 12 – Disaggregation, presentation and disclosure of contribution-based promises

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 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.

Question 13 – Benefit promises with a 'higher of' option

(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?

With respect to the DP proposal on measurement of benefit promises with a 'higher of' option, our same comments as those made on the measurement for contribution-based promises in our response to Question 9 apply, as both propose the use of fair value measurement.

In addition, with respect to the accounting for 'higher of' options, we believe that other alternative models should be considered by the Board, including accounting for the 'higher of' options based on the most likely outcome at each reporting date, similar to the model used in IFRS 2 *Share-based Payment*. In a period in which an outcome of one option becomes more probable than another, the change in measurement would be recognised in full in that year. In this example, no fair value would be recognised for the other non-probable option. We believe that this approach would represent less of a fundamental change to the current principles of IAS 19, compared to the DP proposals of recognising an option value that does not reflect the potential outcome of either of the options within the benefit promise.

Question 14 – Other matters

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

We do not have specific disclosures to mention at this stage in the project; however, see our response to Question 15.

Question 15 – Other matters

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

We would like to comment on the DP proposal for a change in the unit of account from a plan to a promise.

Overall, we are supportive of this change as proposed in the DP; however, we recommend that the Board further deliberate the impact that this might have, especially from a disclosures perspective, when there is a pool of assets in a plan that is for more than one type of promise.

Please contact Mary Tokar or Regina Croucher at +44 (0)20 7694 8871 if you wish to discuss any of the issues raised in this letter.

Yours sincerely

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