Memo

To: International Accounting Standards Board

From: Accounting Standards Board – Canada, Staff

Date: September 25, 2008

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

The following comprises the response of the staff of the Canadian Accounting Standards Board (AcSB) staff to the IASB's Discussion Paper, *Preliminary Views on Amendments to IAS 19, Employee Benefits*.

Background

In preparing this response, the AcSB staff consulted with the following:

i) The AcSB's Employee Benefits Advisory Group, which is composed of accountants (preparer and public practice perspectives), actuaries from benefit consulting firms and financial statement users. This Group assists the Canadian member appointed to the IASB's Employee Benefits Working Group in preparing for Working Group meetings. The Advisory Group met twice to discuss the published proposals in depth.

ii) The Academic Advisory Council, which assists the AcSB in understanding academic perspectives on financial reporting issues and communicating its activities to the academic community. It focused on the presentation approaches for defined benefit promises and the proposals on contribution-based promises.

iii) The User Advisory Council, which assists the AcSB in understanding how users, including investors and investment professionals, credit granters in financial institutions, equity and credit analysts, and rating agencies, use financial information and how generally accepted accounting principles could be improved to better meet their needs. It focused on the presentation of defined benefit promises, disaggregation and presentation of contribution-based promises, and disclosure of post-employment benefit promises.

iv) Other interested actuaries and certain AcSB members on an individual basis.

The objective of these discussions was to gather views on the proposals from different perspectives without trying to arrive at consensus positions. However, some common themes emerged that this letter conveys.

Overall comments

Overall, AcSB staff and those consulted are highly supportive of the recognition of all changes in the value of plan assets and in the defined benefit obligation in the financial statements in the period in which they occur. While we heard mixed views on the three presentation approaches for changes in the defined benefit obligation and in the value of plan assets, a common theme emerged — it is important to distinguish operating from financing elements, to separately identify valuation changes, and to supplement these distinctions with appropriate disclosure. This transparency is more important than whether to present these changes within profit or loss or other comprehensive income. However, if the IASB's Financial Statement Presentation project can accommodate a presentation approach that distinguishes operating from financing elements, and separately identifies valuation changes, we believe that changes in the defined benefit obligation and in the value of plan assets should all be presented within profit or loss to improve transparency.

We received a near-unanimous strong negative reaction to the proposal to create a category of contribution-based promises as part of the current project. We believe that the IASB should consider cash-balance plans and "higher-of" plans in its separate Phase 2 project as part of a comprehensive review of employee benefit accounting. We strongly advocate a common, consistent accounting framework for all benefit promises. The current piecemeal approach of addressing contribution-based promises, but not other promises, is seen as confusing and we believe would increase accounting challenges rather than reduce them.

In addition to elaborating on these overall comments, we offer some other comments for your consideration, including some suggested disclosures for post-employment benefit promises in Appendix 1. We also identify areas where the proposals require clarification.

Recognition of defined benefit promises

We support recognizing all changes in the value of plan assets and in the defined benefit obligation in the financial statements in the period in which they occur. We also support the IASB's rationale for this recognition as discussed in paragraphs 2.10-2.11. This proposal is consistent with the views expressed by members of the Canadian Accounting Standards Board[1], the User Advisory Council, and the Academic Advisory Council.

Presentation of defined benefit promises

While AcSB staff heard mixed views on the three presentation approaches for changes in the defined benefit obligation and in the value of plan assets, a common theme emerged — it is important to distinguish operating from financing elements, and to separately identify valuation changes. This approach will enable financial statement users to separate out valuation changes, which tend to be volatile and not necessarily good indications of future performance. In considering the benefits of this approach, we believe that the operating and financing breakdown will provide a clear indication of the treasurer's stewardship around funding decisions and the operation manager's stewardship for service cost decisions.

[1] AcSB staff consulted with the Canadian Accounting Standards Board several years ago on the issue of recognizing all changes in the value of plan assets and in the defined benefit obligation in the financial statements in the period in which they occur.

Overall, we found these distinctions to be more important than whether to present these changes within profit or loss; or other comprehensive income. We stress the significance of using these breakdowns to facilitate transparency of information, rather than grouping these changes into a single number as Approach 1 in the proposals seems to suggest. We note that the distinction between operating and financing elements is consistent with the breakdown proposed in the discussion paper, *The Financial Reporting of Pensions*, published by the European Financial Reporting Advisory Group in January 2008, which supports an approach that distinguishes financing from operating elements. To the extent possible, these breakdowns should be separately identified in the financial statements. However, disclosure may be needed to supplement the financial statement presentation.

We hope that the joint IASB/FASB's Financial Statement Presentation project can accommodate a presentation approach as described above, and also presents changes in the defined benefit obligation and in the value of plan assets within profit or loss to improve transparency. Some financial statement users indicated that presenting these changes in profit or loss would reveal the true volatility of the benefit plan's results. We are concerned with any approach using other comprehensive income, as excluding changes in plan obligations and assets from profit and loss will make them less transparent to financial statement users. We would specifically be concerned with Approach 2 for presenting interest cost in other comprehensive income as this approach excludes financing costs from profit and loss.

We observe that any breakdown of pension costs cannot be mirrored within a cash flow statement because a plan sponsor normally only has information about cash paid/payable to the plan; to employees, their beneficiaries or estates; or to a third-party service provider.

As noted below under Presentation of changes in the liability for contribution-based promises (Chapter 9), we believe that similar components should be determined for presenting changes in the liability for contribution-based promises as for defined benefit promises.

Scope of Phase 1 – contribution-based promises

We received a near-unanimous strong negative reaction to the proposals regarding contribution-based promises. Most people found the application of the concept to be unclear and confusing, while the distinction between contribution-based promises and defined benefit promises is seen as blurred, arbitrary and rules-based.

Final-average earnings plans should be addressed with career-average earnings plans and flat-dollar benefit plans to allow for a common framework. It is difficult to understand how a flat-dollar benefit plan could be classified as a contribution-based promise when a final-average earnings plan is classified as a defined benefit promise since the plans can be viewed as very similar in substance. For example, consider a flat-dollar benefit plan that is subject to annual union renegotiations. There may not be a commitment to renegotiate favourable increases into the benefit plan. However, there may be a past history of the union renegotiating favourable increases on behalf of its members. This expectation of a future benefit increase to the flat-dollar benefit plan is similar to an expectation that future salary increases will increase the benefit of a final-average earnings plan. Both benefits consider inflation-driven expectations. Thus, it is difficult to understand how the proposals could classify this flat-dollar benefit plan differently from a final-average earnings plan. Furthermore, some actuaries would like clarification on whether a flat-dollar benefit plan is a contribution-based promise. Appendix 2 describes a flat-dollar benefit plan.

Other inconsistencies also result from the arbitrary classifications. The proposals scope in promises that accumulate and are then paid out in a lump sum on death, but scope out insurance arrangements with a similar promise leading to inconsistent accounting as a result of the scope limitations. For example, a life insurance plan with $10,000 lump sum payable at death to the beneficiary, provided the employee works until retirement, would be scoped out of the proposals in paragraph 5.11. However, an actuary indicated that he could describe that plan as a benefit of $10,000 on the date of hire with 0% rate of return on the date of retirement, paid out at death. This latter plan would be scoped into the proposals. This example reflects a scope limitation that results from treating pension processes differently from other benefit processes.

We believe that management will have great difficulty explaining the differences in accounting and disclosures for contribution-based promises, as the differences between them result from classifications that seem more arbitrary than the current defined contribution/defined benefit distinction.

We are concerned that different measurement bases for contribution-based promises and defined benefit promises will create significant inconsistencies in accounting for similar obligations and introduce “game playing” at the boundaries to achieve desired accounting results. Financial statement users are concerned that these different measurement bases will result in a lack of comparability. We fear it will be confusing to preparers and financial statement users, and will not be seen as providing a faithful representation.

Accounting for cash-balance plans is not a significant issue today in Canada, although we appreciate that it may be a problem elsewhere in the world. The introduction of contribution-based promises and resulting reclassification of some defined benefit promises such as flat-dollar benefit, career-average earnings and lump-sum retiring allowances to contribution-based promises would create difficulties in accounting for these plans that do not currently exist. We believe that a large number of Canadian defined benefit plans would be reclassified to contribution-based promises as a result of the proposals. In fact, one-half of all defined benefit registered pension plans in Canada are career-average earnings plans and flat-dollar benefit plans, according to recent Statistics Canada data.

We stress the need for one common framework, i.e., to consider the accounting for contribution-based promises and defined benefit promises at the same time. We believe that addressing contribution-based promises without addressing defined benefit promises is at least as problematic as not addressing cash-balance plans. In summary, piecemeal changes to IAS 19 will create arbitrary distinctions and inconsistencies in the accounting model for post-employment benefits.

As a result, we believe that the IASB should consider cash-balance plans in its separate Phase 2 project that plans to take a fundamental look at employee benefit accounting. The Phase 1 project on post-employment benefits should focus on recognition and presentation of defined benefit promises, but it could also consider some short-term improvements of disclosures for cash-balance plans.

Scope of Phase 1 – "higher-of" plans

We believe that accounting for "higher-of" plans should also be considered in the IASB's Phase 2 project as we believe a common framework is required for all promises.

The proposals recognize and account for the host defined benefit promise in the same way as a defined benefit promise, and recognize the "higher-of" option separately. We believe that it may be more difficult to separate a "higher-of" option from a host defined benefit promise than the proposals suggest, as there may be difficulty in distinguishing a real option from an imputed option.

The IASB might consider the US Financial Accounting Standards Board's previous thinking in this area, such as Q&A 47 to the Implementation Guide of Statement 87 on Employers' Accounting for Pensions, which looks at different scenarios.

If Phase 1 continues to consider contribution-based promises

If the IASB decides to continue with the notion of contribution-based promises and not wait until Phase 2, we offer some further thoughts on the measurement of contribution-based promises — core issues, measurement of benefits after the accumulation phase, and the presentation of changes in the liability for contribution-based promises.

Measurement of contribution-based promises — core issues (Chapter 7)

We encourage the IASB to provide application guidance on fair value, assuming the terms of the benefit promise do not change for contribution-based promises. IFRSs do not currently provide guidance on "fair value" for actuarial obligations. Actuaries expressed a common concern over how to determine "fair value" for contribution-based promises and the meaning of "fair value" for contribution-based promises. They were troubled that there may be significant differences in the approaches taken. Some preparers and public practice accountants also expressed a similar concern — many different methods would likely evolve for fair valuing contribution-based promises just as different methods exist for measuring defined benefit promises. They also noted that guidance on fair value in IFRSs is mainly in IAS 39, *Financial Instruments: Recognition and Measurement*, but that standard excludes employee benefits from its scope. IAS 19 currently includes guidance on the fair value of plan assets, but not on the fair value of the obligation. We suggest that application guidance on "fair value" for contribution-based promises be developed, possibly as part of the IASB's Fair Value Measurement project.

Some members of the AcSB's Academic Advisory Council encouraged the IASB to review the section addressing the measurement of contribution-based promises for internal inconsistencies. For example, paragraphs 7.16-.17 call for an expected value approach, and state that estimates of the probabilities associated with each cash flow scenario should be neutral. However, paragraph 7.21 appears to favour a biasing downward of expected future values.

In the discussion of risks, some actuaries noted that other significant risks should be addressed, such as early retirement risks and inflation risk, in the same way that asset-based risk, demographic risk, credit risk, and the risk that the terms of the benefit promise change are addressed.

Measurement of benefits after the accumulation phase (Chapter 8)

Paragraphs 8.3 to 8.10 provide two examples of promises with the same ongoing obligation, but that arise from different methods of accumulation. It discusses the IASB's preliminary view that an obligation should be accounted for consistently throughout its life, while it acknowledges a contradiction with its belief that the same obligation should be accounted for in the same way. We are concerned about having two identical obligations measured in two different ways just because the scope of the project limits improvements in the measurement of contribution-based promises to avoid delays in the project. This approach will not result in faithful representation nor can it provide relevant information. We emphasize that risks and uncertainties inherent in the payout phase are an essential consideration in measuring the obligation. Thus, for an obligation of a contribution-based promise to result in a faithful representation and provide relevant information, it must be based on its characteristics such as the risks and uncertainties inherent in the payout phase.

Presentation of changes in the liability for contribution-based promises (Chapter 9)

We believe that presentation of changes in the liability for contribution-based promises should mirror the presentation of changes in the liability for defined benefit promises, as we see no reason to be different. We stress that consistency is important in terms of presentation. Accordingly, we also believe that similar components should be determined for presenting the changes in the liability for contribution-based promises as for defined benefit promises[2] and acknowledge that this outcome is driven by the ability to disaggregate the components of a contribution-based promise. It would be confusing to financial statement users to disaggregate changes in the value of a contribution-based benefit liability differently from changes in the value of a defined benefit liability.

We suggest that the IASB determine what disaggregation of changes in the value of contribution-based promises is useful and whether there would be any practical difficulties in obtaining it. Paragraph 9.7 of the proposals discusses that many interrelated assumptions are used in determining the fair value of a liability, and states: "These interrelated assumptions mean that any disaggregation of interest cost and other fair value changes would not be possible to achieve objectively." We observed mixed views on whether it is possible to disaggregate interest costs and other fair value changes for contribution-based promises to enable a consistent approach with defined benefit promises. The Joint Working Group on Financial Instruments identified some difficulties with a similar exercise, but some actuaries did not see a problem. They failed to understand the differences between contribution-based promises and defined benefit promises that resulted in the above statement.

Clarification in certain areas

Presentation approaches for defined benefit promises (Chapter 3)

We think that clarification is needed as to how adjustments arising from the limit on the benefit asset factor into the presentation approaches. Specifically, under Approaches 2 and 3, would the

[2] See the discussion, Presentation of defined benefit promises, for our suggested approach.

effect of the limit on earnings be recorded in profit and loss or in other comprehensive income? Our preference would be to recognize the adjustment in profit or loss to improve transparency.

Definition of contribution-based promises (paragraph 5.50)

Post-retirement plans that provide a fixed annual contribution per year of service into a Health Care Spending Account are becoming popular in Canada. If the benefit was provided in cash, it would be a contribution-based promise. Under the proposals, the fact that the promise is provided in the form of a payment to third parties for medical services might result in this plan being classified as a defined benefit promise under paragraph 5.11 depending on whether the plan is viewed as a "typical" medical care promise. We think that clarification is needed as to its classification.

Discount rate for contribution-based promises (paragraph 7.19)

We think that clarification is needed as to the discount rate to be used to measure contribution-based promises. Some suggested that it may be the same rate as that used to measure post-employment benefit obligations in IAS 19.78-.82, while others suggested that the reference to the time value of money in paragraph 7.19 of the proposals coupled with the discussion of various risks in subsequent paragraphs is more consistent with the guidance in IAS 39.AG82 than IAS 19.79-.82.

We would be pleased to elaborate on this response in more detail if you require. If so, please contact Peter Martin, Director, Accounting Standards at +1 416 204-3276 (e-mail peter.martin@cica.ca); Mark Walsh, Principal, Accounting Standards at +1 416 204-3453 (e-mail mark.walsh@cica.ca, or Nancy Estey, Principal, Accounting Standards at +1 416 204-3271 (e-mail nancy.estey@cica.ca).

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Appendix 1 – Disclosures for post-employment benefit promises

We suggest the following disclosures for post-employment benefit promises as a result of our consultations with various groups:

- IAS 19's current requirement for disclosure of the fair value of plan assets focuses on "each major category". Financial statement users would like specific details regarding securities held in the portfolio of plan assets for funded plans as they would like to assess whether the type of assets are matched to the type of obligation. For example, financial statement users are especially concerned that some portfolios such as private equity investments, leveraged recaps, hedge fund pools and other alternative investments have betas far above any implied "risk-free rate" in the discount rate. (IAS 19.120A(j))
- Effective date of the most recent actuarial valuation for funding purposes and the effective date of the next required actuarial valuation for funding purposes. Currently, EMPLOYEE FUTURE BENEFITS, Section 3461 of the CICA Handbook – Accounting, requires these disclosures in paragraph 3461.154(b), whereas, IAS 19 does not. Financial statement users consider whether future cash outflows for employee future benefits might be significantly different than those for the current year. Accordingly, financial statement users find the effective date of the last actuarial valuation for funding purposes important in understanding the current required funding, while the effective date of the next valuation determines when the required annual funding amount will change.
- IAS 19 currently has a requirement to disclose the employer's best estimate, as soon as it can reasonably be determined, of contributions expected to be paid during the annual period beginning after the reporting period. Since some employers may opt to contribute more than the minimum, financial statement users would like employers to provide a range for these expected contributions. (IAS 19.120A(q))

Appendix 2 — Flat-dollar benefit plan

Example of a typical union negotiated hourly wage flat dollar defined benefit pension plan

The plan provides for a normal retirement allowance, a postponed retirement allowance and an early retirement allowance (as well as special and supplementary retirement allowances). The normal or postponed retirement allowance is described as:

> The monthly Normal Retirement Allowance or Postponed Retirement Allowance upon retirement on or after Normal Retirement Date shall consist of a benefit multiplied by the number of years of the Member's Credited Service in accordance with the following schedule:

- $22.00 if retirement occurs on or after January 5, 1987, but prior to January 1, 1988; or
- $23.00 if retirement occurs on or after January 1, 1988, but prior to January 1, 1989; or
- $24.00 if retirement occurs on or after January 1, 1989, but prior to January 1, 1990, and

Effective January 1, 1990:

- $29.50 if retirement occurs on or after January 1, 1990, but prior to January 1, 1991, or …

Similar provisions are indicated for years after 1991.