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The International Accounting Standards Board
1st Floor, 30 Cannon Street
London
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Dear Sir

Subject: 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".

We have included detailed responses to most of the questions asked in the Discussion Paper in an appendix. The following summarizes our major reactions to the Discussion Paper as a whole:

- We support immediate recognition in the company balance sheet of actuarial gains and losses; however, we believe that immediate recognition of actuarial gains and losses in the profit and loss account (as financial reports are currently structured) provides a misleading picture of how typical pension plans operate.

- In our view, it is not appropriate to develop a new presentation of pension expense when the format of the income statement is under review. The current option to recognise actuarial gains and losses through the Statement of Recognised Income and Expense provides an adequate approach to achieve the goal of immediate balance sheet recognition.

- We welcome the idea that plans that are essentially defined contribution should be accounted for on a defined contribution basis rather than a defined benefit basis as at present. However, we have several concerns about the work on contribution-based promises:

  – The paper suggests that many plans where there is currently no problem with the accounting treatment will be classified as contribution-based promises. This goes beyond the objective of correcting current problems. Unless the IASB first reviews pension plans more broadly, the amendments should be limited to dealing with plans where there are current problems.

- We would prefer the same basic principles to apply to all types of post-retirement benefit plans. It is not appropriate to exclude final salary and post-retirement medical plans from the consideration of new accounting approaches. Although the intention is to leave consideration of final salary plans until later, it is clear that many of the ideas considered in the paper would also apply to final salary plans.
- We welcome the proposal to base liability accrual on the plan's benefit formula, but believe that it may be necessary to adopt a different approach where there is significant back-loading to benefit accrual or vesting.

- The proposals on the selection of a discount rate for contribution-based promises are complex and subjective. The arguments for moving away from AA-rated bonds, and the consequent loss of comparability, are not compelling.

We appreciate your consideration of these comments and those in the appendix. If we can provide any assistance or further clarification, please do not hesitate to contact Phil Turner at 01243-522560 or via e-mail at phil.turner@mercer.com.

Yours faithfully

J. Philip Turner.

Phil Turner
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Appendix

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 consider that the Discussion Paper goes well beyond dealing with issues that cause problems for preparers in applying IAS 19. For example, there are no major problems with valuing career average plans but the treatment of these would be changed under the proposals.

Question 2: Are there factors that the Board has not considered in arriving at its preliminary views (on deferred recognition of changes in the liability)? If so, what are those factors? Do those factors provide sufficient reason for the Board to reconsider its preliminary views? If so, why?

Chapter 2 notes the Board's preliminary view that entities should not divide the return on assets into an expected return and an actuarial gain or loss. It appears that this conclusion has been reached without considering the difficulties raised by embedding a significant source of actuarial gains and losses (for most funded pension plans) in an item of expense that passes through the profit and loss account. In order to recognise actuarial gains and losses in other comprehensive income, it is necessary to identify an "expected return" on assets. Until such time as the review of financial statement presentation is completed, the concern about profit and loss manipulation (paragraph 2.15) would be better addressed by stricter standards on the selection of the expected rate of return assumption. This would allow the continuation of the current format for pension expense.

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?

We see no compelling reason to move away from the general format for presenting pension expense that is used currently (current service cost, interest cost, expected return on assets, actuarial gain/loss). Investors are now familiar with this format and important information is provided about accrual costs, financing costs, and re-measurement items. This is essentially approach 3.

We agree with the comments in the Discussion Paper about the different "predictive value" of ongoing and re-measurement items and consider that these should be separated between profit and loss and other comprehensive income as under FAS 158, FRS 17 and the immediate recognition (SORIE) option under IAS 19. We have no particular view about whether the latter should be "re-cycled".

(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?

We consider the separation of re-measurement costs into other comprehensive income provides valuable information to users about the nature of these costs.

(c) What would be the difficulties in applying each of the presentation approaches?

No comment.

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?

No comment.

Question 5: Do you agree that the Board has identified the appropriate promises to be addressed in the scope of this (contribution-based promises) project? If not, which promises should be included or excluded from the scope of the project, and why?

No. We consider that the scope of this project is far too broad. Although the use of defined contribution accounting for plans that are essentially defined contribution (but must currently be accounted for on a defined benefit basis) would be welcome, this could be achieved more simply.

There are no current valuation issues with many of the plans covered by the proposed new category. However, this proposal creates new valuation issues and inconsistencies for these plans. There is a fine dividing line between career average plans and final salary plans. Some career average plans are currently treated as final salary on the basis of a constructive obligation to increase benefits in line with salaries. Some final salary plans have long averaging periods, and it would appear that leaving one year off the averaging period for a career average plan would alter the intended new classification. This is not a good dividing line for defining a radically different treatment.

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?

Yes, there are many plans that provide flat, fixed or career-average benefits. For example, in Canada approximately one third of plans provide benefits on a flat or career-average basis, and these plans often also include benefits on a final salary basis.

Many companies have moved from final salary to career average plans (in some cases retaining the final salary link for past service benefits), and the separation of pension benefits between those accrued as final salary benefits and those accrued as contribution-based benefits would make valuing them difficult. There is no obvious basis for the allocation of assets between the final salary and career average parts of such a plan. The presentation of expense would depend on how this is done.

Question 7: Do the proposals achieve that goal (making no significant change to the valuation of pure defined contribution plans)? If not, why not?

Yes, the proposals achieve that goal, but only if calculation and disclosure of the benefit obligation is not required for pure defined contribution plans.

Question 8: Do you have any comments on those preliminary views (on recognition of contribution-based promises)? If so, what are they?

We believe that a single basis of recognition should apply to all pension plans. Our starting point would be that "present obligations" are the benefits that would be provided by the company if the pension arrangement were terminated. This is not always a clear definition, and a more practical definition which achieves broadly the same objective would be to consider "present obligations" as benefits accrued in accordance with the accrual formula without regard to vesting. This is a suitable starting point for the definition of liabilities, but it will not be an adequate definition in all circumstances. For example, some plans do not provide an accrual formula and others are excessively back-loaded. In our view, this is not an adequate definition of liability for these plans.

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.

We consider that the same basic measurement approaches should be used for all retirement plans. It is therefore inappropriate to consider the measurement basis for contribution-based promises in isolation.

In our view, the proposed measurement basis for contribution-based promises is far too subjective and will lead to inconsistent valuations of identical benefits.

We agree that the discount rate should reflect the time value of money but not that it should necessarily be a "risk-free" rate. For example, in the UK, the Pension Protection Fund levy is charged to the profit and loss account. It is consequently wrong to treat the balance sheet item as risk free. However, it is better for investors to have a consistent measure so the liabilities of different companies are directly comparable. Given the mix of funded and unfunded schemes to which pension accounting standards apply, the use of the yield on AA-rated corporate bonds seems reasonable. In the absence of a widely-recognised alternative, we see no compelling reason to move away from the use of an AA-rated corporate bond yield.

The use of a risk-free discount rate at the present time would place pension liabilities on a different footing from other items in the company balance sheet – most notably the value of its own corporate debt. This would exaggerate the significance of pension liabilities in the balance sheet.

(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?

As discussed above, we consider that the yield on AA corporate bonds is a suitable discount rate for typical pension benefits.

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?

We believe the same basic valuation approach should be used for all benefits at all times.

(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?

The proposed measurement basis for contribution-based promises is far too subjective and will lead to inconsistent valuations of identical benefits.

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?

The same approach should apply to contribution-based promises as to other benefits. It is possible to simplify the disclosures for pure defined contribution plans (as at present).

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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?

The same approach should be used for all plans where possible, though the calculations and disclosures for pure defined contribution plans may be simplified, as noted above.

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?

In many cases, the 'higher of' option is not fixed e.g. in Switzerland the guaranteed annuity rate may be changed when financial conditions change, and in Belgium the guaranteed investment return is periodically adjusted. In these cases, it may be inappropriate to anticipate that guarantees continue indefinitely at the same levels.

(b) Do you have any other comments on the proposals for benefit promises with a 'higher of' option? If so, what are they?

In our view, a strong materiality exemption should be provided to avoid lengthy and difficult calculations for relatively minor benefits.

Question 14: What disclosures should the Board consider as part of that review?

No comment.

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

No comment.