IAS 19 Discussion Paper Comment Letters

International Accounting Standards Board

30 Cannon Street
London EC4M 6XH, United Kingdom

Our ref: RRD\DP

Contact Régis Renard
☎ +32 2 730 97 07
regis_renard@aon.be

Sent electronically

Brussels, 26 September 2008

Dear Madam, dear Sir,

Subject: Discussion paper – Preliminary Views on Amendments to IAS 19 Employee Benefits

Aon Consulting Worldwide (ACW) is pleased to herewith submit its comments on the discussion paper (DP) "*Preliminary Views on Amendments to* IAS 19 Employee Benefits".

ACW really appreciates the opportunity given by the IAS Board to participate in the revision process of *IAS 19 "Employee Benefits"*.

The following paragraphs include our comments and suggestions on some points and issues.

Scope of the Project

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?

The DP mainly addresses four issues:

1) elimination of deferred recognition of changes in defined benefit (DB) promises;

We understand that deferred recognition mechanisms are not in line with the *Framework* and other IFRSs (such as *IAS 8*). They should therefore be eliminated. However, we also understand (and we welcome the initiative) that IFRS/IAS and SFAS standards should converge in a near future. The FASB has already taken some steps in this respect (cf. *SFAS 158 Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*). *Certainly in this context, we agree that this topic should be treated as a priority*.

2) presentation approaches for Defined Benefit (DB) promises;

We understand that on a more general basis, presentation issues are covered by another project (revision of *IAS 1 Presentation of Financial Statements*). By treating DB promises presentation issues apart, we are concerned by possible inconsistencies with the specific 'Presentation' project

Furthermore, as far as DB promises are concerned, we think that presentation issues are tightly linked to measurement issues. DB promises are currently measured (and we understand this will not change in a near future) as a present value based on a mark-to-market discount rate. This makes the Defined Benefit Obligation (DBO) very volatile. But pensions are typically <u>long-term</u> obligations; the measurement method should recognise this, especially in an accounting framework resulting in immediate recognition of changes.

We would therefore advise to postpone this topic <u>or</u> at least to couple the analysis with the revision of DB promises <u>measurement</u> and the '<u>Presentation</u>' project. In this respect, we would invite re-considering the following topics:

- The re-cycling approach (through OCI) adapted by *SFAS 158*.
- The nature of the discount rate (should it be a settlement rate, a risk-free rate, some rate linked to the return on plan assets,…).

3) contribution-based promises: definition, measurement, recognition and presentation;

We are happy that the IASB Board acknowledges that the current IAS 19 text is not adapted to some types of promises very popular in some countries where IAS/IFRS standards must be applied. In our opinion, the solution proposed should offer some continuity as to current practices and better reflects the economic reality underlying the promises falling into the contribution-based category.

4) benefit promises with a "higher of" option.

This seems natural to tackle this type of promises as from the moment that contribution-based promises are treated specifically.

Recognition and presentation of defined benefit promises

<u>Question 2</u>
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?

As mentioned in our comment on Question 1, we fear that tackling this issue without considering the <u>measurement aspects</u> might hamper the faithful representation of the company's position. Under the current measurement method, the proposed recognition and presentation methods, the long-term maturity of the pension obligations is NOT taken into account. We think that there should be some mechanisms recognising the long-tem maturity of pension obligations and mitigating the impacts of punctual/extra-ordinary market fluctuations. This is what the corridor rule was meant for. Alternatively, some stability in the profit and loss (P/L) account could be maintained by using SFAS 158's re-cycling technique.

As far as the *return on plan assets* is concerned, we think the actual return on asset is more transparent information. We would recommend to require the disclosure of the *expected* return on plan assets, for information purposes.

The recognition of *unvested past service* in the period of plan amendment seems to best comply with the 'service matching principle' (see Objective of IAS 19, page 19-9 of the standard): in most cases, the incremental (positive of negative) benefits resulting from a plan amendment matches services rendered in the past.

We are not convinced that, for example, the economic benefit arising from services rendered by an employee hired just after the amendment (not concerned by the Past Service Cost) and an employee having exactly the same profile but hired before the amendment (concerned by the Past Service Cost) will be different during the vesting period.

The comparison with *IFRS 2 Share-based Payment* may not be that straightforward: in most of the cases, share-based payments are granted as an incentive to remain with the company. Suppose two employees having the same profile and skills and that only one is entitled to unvested options. Then, the other one might be more motivated to create value for the company. So, here, the recognition over the vesting period seems 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?

1)Approach 1 – All changes through P/L

Pros

- This approach seems to be more consistent with framework.
- Simple, transparent and easily understandable.
- Enhances comparability.

Cons

- Increased volatility in the P/L.
- The post-employment obligation is a long-term obligation.
  In this context, the increased volatility may hamper the relevance of the Financial Statements. On the long term, the short-term volatility of post-employment obligations may not be relevant to the decision-making needs of the users.
  In the same order of idea, under *IAS 39 Financial Instruments*, when financial instruments are meant to be held until maturity, they are accounted by using a method (the so-called *amortised cost* method) resulting in more stability in the financial accounts. In other words, punctual fluctuations will not affect the financial position of the reporting entity and this, because of the long-term nature of the obligation contracted.

2) Approach 2 – Service Cost through P/L, the rest through OCI

Under this approach:
- The Service Cost (and assimilated items such as a Past Service Cost or a Curtailment impact) is recognized through the P/L. We also understand that experience gain or loss should also be recognized through P/L.
- All other items (incl. Interest Cost, impact of changes in the discount rate and all changes in plan assets value) are presented in OCI.

Pros
- The P/L seems to be more predictive (more relevant information) with respect to the elements most under the entity's control. For example, the discount rate depends on the market conditions rather than on a decision process of the company.
- Makes the P/L more stable than with Approach 1, which seems better reflect the long-term feature (and hence long term risk) of the contracted obligation.
- Offsets financial cost/gain: the Return on Plan Assets offsets the Interest Cost. This would make sense to many users from an economic perspective.
- Enhanced comparability.

Cons
- About the first bullet point above: the Service Cost depends to some extent on the discount rate used (as of the beginning of the reporting period).
- In some jurisdictions, the Return on Plan Assets actually depends to a large extent on the entity's decision to invest in volatile plan assets. In other words, the origin of the volatility clearly results from a management decision. So, as such, the Return on Plan Assets should have an impact on the P/L of the reporting entity.
- All financing aspects (incl. Interest Cost) of the obligation are recognized in OCI. The consistency with other standards can be questioned.

Approach 3 – Service Cost through P/L, the rest through OCI
Under this approach:
- The Service Cost (and assimilated items such as a Past Service Cost or a Curtailment impact), the Interest Cost and the Interest Income (e.g. coupons and cash dividends) are recognized through the P/L. We also understand that experience gain or loss should also be recognized through P/L.
- Other items (incl. impact of changes in the discount rate and all changes in plan assets value), actually re-measurements, are presented in OCI.

Pros
- The P/L seems to be more predictive (more relevant information) with respect to the elements most under the entity's control; i.e. items not subject to re-measurement impacts due the exogenous parameters.
- Makes the P/L more stable than with Approach 1, which seems to better reflect the long-term nature of the contracted obligation.

Cons
- About the first bullet point above: the Service Cost, Interest Cost and, to some extent, the level of Interest Income depend on market conditions.
- More complex and transparent (probably for the shareholder/stakeholders).
- Partially offsets financial cost/gain: the Interest Income (but not the capital gain/loss effects) offsets the Interest Cost. This would make less sense from an economic perspective. The financial impact cannot be evaluated without the capital gain/loss impact. Identical

investment may or may not distribute any intermediate income. They will be treated differently.
- Consistency with other standards may not be assured (e.g. *IAS 39 Financial Instruments*).
- Heavy to implement: how to estimate Interest Income?
  1. Expected Return on Assets: include capital gain/loss (certainly for equities).
  2. Actual dividends and coupons: not always possible to have the information in due time. Moreover, plans with exactly the same plan assets but different vehicles may report different numbers.
  3. Market yields based on high quality corporate bonds: may be quite an arbitrary measure in case of low correlation between the actual Interest Income and the used market yields.
- Comparability hampered because of the above bullet points.

As a conclusion:
- We would again strongly advise to wait for the outcome of the revision of *IAS 1 Presentation of Financial Statements* in order to keep the maximum of consistency across all standards.
- Nevertheless, we think that Approach 1 is not adapted to the current measurement methodology. Approach 2 may not be consistent with other IFRS/IAS standards. Although all the proposed approaches can be seriously criticised, *Approach 3* is, in our view, better in line with the pursued objective (transparency and economical relevance). This approach is however difficult/expensive to implement because of the difficulties in determining a relevant picture of the Interest Income in due time.

(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?

For transparency purposes, we think the level of information should not be more aggregated than it is now. It would also useful to some users to have a clear distinction between *Operating Cost* and *Financial Cost*.

For consistency reasons, we are in favour of the same level of disaggregation for fair value (where possible, please see Question 11).

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

Please see point (a) above.

Question 4
(a) How could the Board improve the approaches discussed in this paper to provide more useful information to users of financial statements?

As mentioned earlier, some users would appreciate to have a clear breakdown between *Operating Cost* and *Financial Cost*. We would also advise to add some sensitivity analysis on the key parameters (*ceteris paribus*) and disclosing the expected return on (plan) assets by asset category.

(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 pointed out in Question 3, we think that useful information to the users certainly means information reflecting the economic reality. As such, post-employment benefits, by definition, create long-term obligations. In this respect, from an economic perspective, in our opinion, the financial accounts should not be directly impacted by fluctuations of market data. This would clearly be the case if the corridor rule is removed, because the discount rate is a volatile market-information.

In order to ensure more (long-term) stability, ideas could be to:

- Re-visit the concept of discount rate under IAS 19: for example by reference to a *settlement* rate (although we know this approach has been rejected in the past) – or to some kind of risk-free rate, some rate linked to the return on plan assets. This would not be necessarily against the basic principles of IAS 19: under the current text, the DBO of DB promises is a present value (not a *fair value*).
- Re-discuss the opportunity to use SFAS 158's recycling technique.

Definition of contribution–based (CB) promises

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?

The proposed definition is

> *A* contribution-based *promise is a post-employment benefit promise in which, during the accumulation phase, the benefit can be expressed as:*
> *(i) the accumulation of actual or notional contributions that, for any reporting period, would be known at the end of that period, except for the effect of any vesting or demographic risk; and*
> *(ii) any promised return on the actual or notional contributions is linked to the return from an asset, group of assets or an index. A contribution-based promise need not include a promised return.*

This definition sometimes seems too restrictive and sometimes too broad.

From one hand, in Belgium for example, (Defined Contribution) DC promises have all become DB plans under the current IAS 19 because the legislator requires the employer to bear a minimum return guarantee on the contributions paid. The level of the guarantee is fixed by the legislator. As such, those promises would NOT classify as contribution-based promises, since the promised return is NOT linked to the return from an asset, group of assets or an index.

However we understand that these Belgian promises are typically promises for which this new category has been created.

From another hand, condition (i) of the proposed definition ([…] contributions […] would be known at the end of that period […]) could be clearer:

From our viewpoint, Paragraph 5.27 is clearer when it states that such promise "*requires that the contribution for any period* is known at the end of the period *of the reporting period to which the contribution relates*".

For example: in Belgium, many defined benefit plans ("genuine" DB plans under the new definitions) are funded through individual capitalisation (level annual premiums) with insurance company (offering a known return guarantee, at least on the (level) of the premiums already paid). One could argue that in such cases, under the proposed definition, the promise could be considered as a contribution-based promised: the promise can be expressed as the accumulation of actual contributions that are known (claimed by the insurance company) at the end of the reporting period to which they relates.

We would hence advise to make it more precise that all contributions relating to a given reporting period should be known at the end of that reporting period. In the Belgian example, only a part of the contributions relating to a given period are known by the end of this reporting period. Of course, this is also made clearer when reading Paragraph 5.11 (salary risk in the case of DB promises). But it would be important to refer to this in the definition itself.

We also understand that economically identical promised (possibly expressed in different ways) should be accounted in the same way. This leads to reclassify some promises that were explicitly considered as DB promises in the current text. See Example (d) of IAS19.52 [fixed lump sum at retirement age non dependent on service].
Some promises provide a fixed lump sum with vesting conditions (e.g.: Example 2 of IAS19.70). To the extent that this promise could be expressed as a single contribution during the first period and then a 0% return on the contribution, it would be accounted like a contribution-based promise and no longer as a DB promise (with accrual until the date upon which service conditions are met, as in Example 2 of IAS19.70).

In practice, the *design* (the basic mechanism is: considering the contribution relating to a period as a base for determine the benefit earned during this period), the presence of salary risk together with the promised return are more relevant (see answer to next question) than then economic reality (being economically identical) as classification criteria.

We would however not recommend to use too many categories and to refine the definition in order to *only* include those promises where the current DB treatment makes little sense. For transparency and information purposes, the concepts used in the definitions should be kept simple and understandable by users.

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?

We have already given an example of reclassification in the answer to the previous question. The definition may result in massive reclassification issues in the Netherlands (*career average salary promise*) and in Germany (*flat currency unit promises)*.

The main difficulties would be to manage the accounting transition from one framework to the other one. The impact on the financial statements will be highly material.

Question 7
Do the proposals achieve that goal? If not, why not?

The proposal does not fully achieve its goal: it does not solve some issues that it should (such as the Belgian problematic exposed in the answer to Question 5) and creates unnecessary issues in some other situations.

Recognition issues related to contribution–based promises

Question 8
Do you have any comments on those preliminary views? If so, what are they?

We agree with the propositions. This is in line with the treatment of other types of benefit and, hence, contributes to maintain consistency throughout the standard. Accordingly, unvested promises should be recognised as a liability, no additional liability should be recognised when an employee leaves immediately after the reporting date and benefits earned should be allocated according to the benefit formula without allowing any departure.

As to the latter point (benefit allocation), we would like to stress the importance of Paragraph 6.8, first bullet point:

> […] *IAS 19 requires:*
> - *no departure from the benefit formula for* defined contribution plans. *For example, if a defined contribution plan promised a benefit of contributions of 5 per cent of current salary for the first ten years of service and 10 per cent for the next ten years, the fact that the benefits earned in later periods are higher than the benefits earned in early periods would not affect the accounting.* <u>Entities would not make an accrual in the early periods for the higher benefits to be earned in the later periods</u>.

We can deduce that within a normal DC promise, the benefit earned during a period a service results from the contribution paid during the same period **without considering future contributions.** The latter ones will be earned in exchange of service rendered in the future.

The underlined sentence is fundamental: it ensures the promise accounting comply with IAS 19's primary objective (see Page 19-9 of the Standard):

> *The Standard requires an enterprise to recognise:*
> *(a) a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and*
> *(b) an expense when the enterprise consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.*

In virtue of this ‘service-matching principle’, it appears natural not to make any accrual in the early periods for contributions paid in later years (in this, in opposition to the proposition of the ever-discussed exposure draft *D9 Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions*). So we would suggest to keep this principle in any other possible CB(-like) approach, because it is, in our opinion, the best way to match the cost of employee benefit with the service rendered. This practically means that it should be clear that, in the case of a DC promise with promised return, the Projected Unit Credit in the IAS 19 context (see Objective of the Standard) yields the same results as applying the Unit Credit Method.

If the IAS Board decided to keep the existing classification (DB and DC promises only), we would invite the IFRIC to issue an official interpretation in that sense (for “contribution-based” promises remaining DB promises), in order to fill in a gap leading to too different interpretations in some jurisdictions.

Measurement of contribution–based promises

<u>Question 9</u>
(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 agree with the <u>fair value</u> approach. This approach is in line with the measurement of other elements also including embedded items (see *IFRS 2 Share-based Payments*, *IAS 39 Financial Instruments*). It however introduces some discrepancy/discontinuity in the measurement of employee benefits: DB promises are not measured at fair value and according to the proposed definition, some promises would clearly move from DB to CB.

Again this addresses the issue of re-thinking the measurement method for DB promises together with CB promises.

As far as the fair value measurement (Chapter 7) is concerned, we would like to address some technical points:

In determining the cash flows, the probability of all possible outcomes should be considered. (Paragraphs 7.16 and ff.). Then, in order to consider the time value of money, these cash flows have to be discounted (Paragraph 7.19). This calculation results in a present value.

From an actuarial perspective, there are many ways of calculating a present value of cash flows in an uncertain universe (with other words: allowing for risk). Among the most popular frameworks:

a) Use the observable cash flows and probabilities but discount with an adjusted discount rate.
b) Use the "risk neutral" cash flows and probabilities but discount with a risk-free discount rate.

Framework a) is usually used in the insurance world to calculate an embedded value of an insurance company.

Framework b) is often used in the financial world for pricing instruments. Please note that:

- This framework assumes that there is no arbitrage opportunity.
- This framework may be used under *IFRS 2* (equity-settled share-based transactions by reference to the fair value of the instruments granted) when using the Black-Scholes-Merton formula (although there is no market for these instruments and that the non-arbitrage condition may not be met).

Under Framework b), the cash flows used are not those that are observable, while they may be consistent with market prices, if discounted with the risk-free rate.

It is not so clear whether the IASB is meant to accept any kind of method or not. As underlined above, the choice of the method has an impact on the way the discount rate should be chosen.

We also think that (like in *IFRS 2*) the use of the intrinsic value should be allowed when the fair value is not available through market or the use of appropriate valuation models.

(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?

We think the question of the inclusion of risk (in particular, credit risk) should be analysed together with the conclusion of the on-going 'Fair Value' 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 agree that the measurement during the accumulation phase should be made according to the classification of the promise, disregarding what can happen during the payout and deferment phases. In many cases, the classification of the promises may change during those phases. It is often not possible to value these options in an objective way. The choice made by an employee for one option rather than for another one is seldom rational and similar options do not exist on the markets. Furthermore, we are not convinced that the benefit derived from such valuation would exceed the cost of determining it.

In this respect, when valuing the obligation in the accumulation phase, we would recommend to use the best estimate as to the options left to the employee. For example, where the employee can choose between the payment of an annuity or a lump sum but that 90% of them choose the lump sum, this rate should be used in the calculation of the obligation.

We however reject the approach of keeping the measurement method used during the accumulation phase for the payout and deferment phases: following this, identical promises (after accumulation phase) would be recognised, measured and presented in different ways. This does not promote comparability and transparency of the financial statements.

We would rather recommend to allow reclassification after the accumulation phase according to the classification of the promise at that moment.

Disaggregation, presentation and disclosure of contribution–based promises

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?

For consistency and transparency reasons, we would advise to keep the same level of disaggregation for both DB and CB promises; certainly in view of Question 10.

(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?

Where the new CB classification really matters (basically, promises consisting of a pure DC promises and an embedded option), the following structure can be identified:

DC component:

- Service Cost: (notional) contribution paid.
- Interest Cost: calculated with the return on plan assets/promised return.
- Actuarial Gain/Loss: results from the difference between actual and expected values.

Embedded Option

- Service Cost: difference between the values (as of beginning of the reporting year) of the option at the beginning and at the end of the period. The option, at the end of the period, valued as of the beginning of the period, corresponds to a forward-start option considering one additional year of service. Options are (fair-) valued by using valuation models under other IFRS.
- Interest Cost: reflects the impact of time on the option's value (this is the factor that financial quantitative analysts call θ).
- Actuarial Gain/Loss: results from the difference between actual and expected values.

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?

For consistency and transparency reasons again, we would advise to keep the same presentation scheme for both DB and CB promises.

Benefit promises with a 'higher of' option

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?

Where both promises are deeply mutually embedded, it can be difficult to isolate each one. If it can be shown that one promise is clearly more material than the other, we would recommend to allow performing a single valuation, in virtue of the 'substance over form' principle.

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

The treatment of the option (measurement, recognition and presentation) should follow the same treatment as the option embedded in a CB promise.

Other matters

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

- The expected return on plan assets (by asset category) should be given in the disclosures.
- A sensitivity analysis of the obligation with respect to main parameters (e.g.: discount rate, inflation, mortality, withdrawal, retirement age) should be performed *ceteris paribus*.

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

We would like to stress again the interactions between measurement and presentation issues for DB promises.

This ends the comments and suggestions that ACW wishes to submit to you.

Should you have any question on this letter, please feel free to contact us. In the meantime, we remain at your service for any additional information needed.

Yours Sincerely,

Aon Consulting Worldwide

Any question on this letter can be addressed to

Régis Renard
Senior Consulting Actuary

Aon Consulting Belgium
Avenue Van Nieuwenhuyse 2
BE-1160 Brussels
☎ +32 (0)2 730 97 07
regis_renard@aon.be