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Sir David Tweedie
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Dear Sir David,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, I appreciate the opportunity to comment on the Discussion Paper *Preliminary Views on Amendments to IAS 19 Employee Benefits* (March 2008). Principal authors of this comment letter were Otto Altenburger, Leopold Fischl, Christoph Krischanitz, Dieter Nefischer, Gerhard Schwartz and Hartwig Sorger.

We very much welcome the Board's efforts to improve IAS 19 and are happy to contribute our comments to the debate. We also took an active part in the work of preparing the PAAinE Discussion Paper *The Financial Reporting of Pensions*, and very much support a thorough examination of the issues involved in accounting for pension obligations. Particularly so, because in Austria there is a strong tradition of defined benefit plans, where the benefits are largely not covered by plan assets.

We had high hopes of the Discussion Paper, and were disappointed when instead of attacking the roots of the problem, it merely applied palliatives to the symptoms. It is precisely these palliative measures, however, that are having unpleasant side-effects here in Austria and are making our situation not better but even worse.

We therefore recommend that there should be no amendments of details until there has been a fundamental discussion of the accounting principles applicable to pensions, of the kind presented in the PAAinE Discussion Paper.

Q1. *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 valuation principles applied to assets and to pension obligation liabilities are not currently the same. In particular, the valuation of plan assets at full fair value is not consistent with internal financing, which must be measured in accordance with IAS 39. As an example, in Austria there is an obligation under tax law for a business to hold a certain proportion of high quality assets, which from an economic point of view have the same function as plan assets, although the two things are treated extremely differently in the measurement of assets and their changes in value. If the valuation principles for pension obligations are not permitted to reflect this, then the overall picture of assets and liabilities will be far removed from presenting a true and fair view. The fundamental principles of valuation (fair value, settlement cost, etc.) should first be discussed before changing the rules for the measurement of expense (removal of the corridor, actual income of plan assets, etc.) We are against "quick and dirty" fixes, and see no reason for there to be a limited time frame.

Already at this stage there should be discussion of transitional provisions, because – especially in Austria – the changes in IAS 19 can be expected to have a major impact.

If pension promises are to be redefined for accounting purposes, would this not be a good opportunity to discuss bundled promises as well (e.g., the combination of a pension on reaching pensionable age combined with invalidity insurance during the accumulation period). What are the criteria to be used in classifying a pension promise when it consists of several elements with different qualities, and when must these elements be unbundled?

Q2. *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?*

We have identified a number of potential issues:

- Have the comments on the Fair Value DP and IFRS 4 been taken into account?
- The definition of the fair value of pension obligations is unclear. The use of fair value interest assumptions is not by itself sufficient to ensure a fair market value, since for pension obligations there is an extensive range of material variables that have not been taken into account (embedded options, transaction costs, liquidity, etc.).
- Differences in the method of valuing plan assets (at full fair value) and securities held by the entity itself (IAS 39) are not taken into account. In Austria, at least, this is of material importance, because roughly 80% of defined benefit pension obligations are not covered by assets held in separate pension funds. In this context it is unimportant whether the entity covers its

pension promises internally with financial securities, so that it is subject to IAS 39, or whether the financing comes entirely from operating earnings – in both cases the full fair value principle applied to pension obligations results in economic distortions. In Austria there is in any case an obligation for tax purposes to acquire specified amounts of securities as cover. These securities must be of high quality and be held internally.

- Is it intended that the obligations be measured individually (the change from “plan” to “promise” in the proposed revised definitions suggests this is the case), or on a portfolio basis (cf. the related discussion of the issue for IFRS 4)?
- The net presentation of pension obligations is not fully consistent with other IFRS Standards. In our opinion, where an entity has a valid pension obligation it should disclose the full amount of the commitment, and a net presentation (deducting corresponding plan assets) should not be permissible.

Q3. *(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?

Answer to (a) and (c):

Under present conditions we do not consider any of the three proposed approaches satisfactory.

Approach 1: This appears to be the most compatible with fair value and is therefore the most consistent approach, at least for pension schemes with separate pension funds, where earnings volatility can be presented realistically. For unfunded or internally funded pension promises, however, there are problems, because they are rarely financed through the trading portfolio, and therefore changes in the measurement of assets are not fully reflected in profit and loss. This increases earnings volatility, for which there is no economic justification.

Approach 2: There is a fundamental problem with separating interest and service cost: Service costs are also dependent on interest rates, since they require to be discounted. For pension obligations funded out of operating rather than financial earnings, this would in principle appear to be the better solution.

Approach 3: This appears to be a compromise. In our view, a distinction between interest cost and expense resulting from interest rate fluctuations makes little economic sense, particularly since in future it will no longer be the expected income on plan assets that will be used, but rather the actual income.

A definitive answer to this question will only be possible when the problems outlined in the answer to Question 2, above, have been solved.

Until that point is reached, we would propose a fourth variant, as a compromise: full recognition of the DBO in the form of a provision, and full but deferred recognition of actuarial gains and losses in profit and loss. This apportionment approach reflects the valuation inertia of long-term illiquid obligations, which are not accurately measured by the PUC's deterministic assumptions. The approach is the liabilities equivalent of the AFS approach for securities, and can appropriately and consistently be applied to internal financing.

Answer to (b):

In our view, disaggregation of fair value information would be more meaningful. We would recommend breaking down changes in fair values into (1) changes reflecting changes in interest rates, market prices and exchange rates, (2) biometric and other actuarial changes and (3) changes in benefit entitlements (e.g., changes due to the passage of time, or changes in salary or contract) instead of the artificial disaggregation into service costs and interest costs. All three factors contribute to both service and interest costs which therefore cannot be clearly distinguished.

Q4. *(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?

The fundamental problems discussed under Question 2 must be resolved first, and then the answers to questions of presentation will be clear. Whether and to what extent changes in pension obligations and their financing should be taken to profit and loss, or disclosed as other comprehensive income, depends primarily on how consistent and informative the underlying methods of valuation are.

Q5. *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?*

Different kinds of promise are not of major importance in Austria: with the exception of severance payments, there are virtually no problems of classification. A discussion of bundled promises (i.e., promises combining different elements) would perhaps be of interest.

Q6. *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?*

In our view, reclassification would be unlikely to be necessary in Austria, because the kinds of promises involved hardly exist, or are not used by enterprises applying IFRS accounting standards.

Q7. *Do the proposals achieve that goal? If not, why not?*

The proposed remeasurement is incompatible in principle and in detail with the established PUC approach. Where pension promises need to be reclassified, large differences can arise on remeasurement. Inconsistent valuation models lead to cherry-picking and arbitrary accounting decisions, so – in answer to the question – "NO".

Q8. *Do you have any comments on those preliminary views? If so, what are they?*

We can in principle support PV9–PV11.

Q9. *(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?

The meaning of fair value, as applied to pension obligations, is unclear. There is no liquid market for them, transfers entail high transaction costs, and pension obligations serve other functions in the entity as well (e.g., motivation, retention management). The proposed method of valuation is linked exclusively to the market for finance, and is thus inconsistent with the principles of occupational pensions.

Risk has its cost, but is less important than other factors (e.g., transaction costs). In the absence of a market, splitting premium margins into liquidity and risk premiums is problematical.

Q10. *(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?

Answer to (a):

In general transaction costs for obligations to pensioners are higher, since payout and transfer negotiations are more expensive than for current employees, who are represented by a works council and/or can be talked to directly. A price differential could therefore be justified, but that has nothing directly to do with the phase of the cash flow, but depends entirely on the status of the beneficiary.

Answer to (b):

Cash flows from pension obligations are not directly hedgeable in financial markets, because death is a random variable independent of financial markets (and in the pension phase, a not inconsiderable one). For this reason it is difficult to establish an appropriate discount rate (corresponding maturity with adequate liquidity). Similarly, the transaction costs associated with the settlement of pension obligations are not reflected by the market, the more so as there is also the question of which market it is (insurance, pension fund, financial markets).

Q11. *(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?

It would appear to be more sensible to break down changes in fair values into (1) changes reflecting changes in interest rates, market prices and exchange rates, (2) biometric changes and (3) changes in benefit entitlements (e.g., changes over time, or changes in salary or contract), instead of into service costs and interest costs. Changes in service costs can be caused by all three factors, and can not be clearly distinguished.

Q12. *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 reasons of consistency option (b) is definitely to be preferred. Differences between defined contribution and defined benefit promises can be minimal in some cases, so the method of presentation should not depend on arbitrary, individual classifications (the principle of consistency should be observed).

Q13. *(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?

The application of option pricing formulas for fair valuation of embedded options as described in IAS 39 is only possible in liquid, arbitrage-free markets. Options on pension cannot be modelled in such markets (not hedgeable), so option pricing formulas are not applicable. The expected value is therefore the only valid alternative.

Q14. *What disclosures should the Board consider as part of that review?*

In our opinion, the collection of additional data will not bring a corresponding gain in information. Aggregated disclosures, which make trends clearly discernible, are of more use to users than individual items of information, where very few users of finance will be able to see the complete picture, which is especially true in the case of pensions.

Q15. *Do you have any other comments on this paper? If so, what are they?*

The Discussion Paper addresses important issues, which is very much to be welcomed. However, individual issues are treated in a very fragmentary way, and their connections both with other pension issues as well as with other IASB projects of relevance to pensions (fair value, IFRS 4, etc.) are often disregarded. We would therefore welcome an overall revision of the Discussion Paper taking into account the problems outlined in our answers to Questions (1) and (2).

Please do not hesitate to contact me if you wish to discuss any aspect of our comment letter in more detail.

Kind regards,

Romuald Bertl
Chairman