International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

Grant Thornton International
Regent's Place
7th Floor
338 Euston Road
London NW1 3BG

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Discussion Paper Preliminary Views on Amendments to IAS 19 Employee Benefits

Grant Thornton International is pleased to comment on the International Accounting Standards Board's (the Board) Discussion Paper *Preliminary Views on Amendments to IAS 19 Employee Benefits* (the Paper).

Our main comments and suggestions on the issues raised in the Paper are summarised below. We have also responded to the Invitation to Comment questions to the extent we have additional comments. Our responses are set out in the Appendix.

Support for the elimination of the 'corridor'

We agree with the Board that IAS 19's deferred recognition (or 'corridor') model should be eliminated. The options available to entities to defer recognition of actuarial gains and losses and report expected returns on plan assets increase complexity, reduce comparability and result in the recognition of amounts in financial statements that have little relationship to economic reality. We therefore support the Board's proposal to recognise all changes in the value of plan assets and in the post-employment defined benefit obligation in the period in which they occur.

We feel that IAS 19's deferred recognition and smoothing mechanism is probably the most serious flaw in the Standard. It is also capable of being resolved relatively quickly. Accordingly we suggest that addressing this area should be the main priority for a short-term improvement project.

Although we support immediate recognition of actuarial gains and losses (including the actual return on plan assets), we are less convinced that IAS 19's requirements on the presentation of those amounts in the statement of comprehensive income should be changed significantly at this time.

Concern over the concept of 'contribution-based promises'

The Discussion Paper proposes a new term 'contribution-based promise' and a definition thereof. The effect of this proposal would be to move the dividing line between what IAS 19 currently refers to as defined contribution and defined benefit plans. This revised 'boundary' is accompanied by a proposal to report contribution-based promises using fair value-based measurements.

The Board's main objective in suggesting these changes is to address perceived problems in the reporting of cash-balance type schemes (schemes that include a promise of a specified return on contributions). The Paper notes that the proposed definition captures career average salary schemes along with certain other arrangements.

We have various concerns over these proposals:

- *Definitions* - the proposed definition of contribution-based promise is considerably more complex than IAS 19's existing definition of defined contribution plans. Although we believe the definition 'works' in terms of capturing the types of scheme intended by the Board, the fact of its complexity may result in other types of scheme being captured. Moreover, whilst we acknowledge that the application of IAS 19 to some types of scheme is problematic, we are not convinced that the problems are of sufficient magnitude to justify the complexity that would be introduced.
- *Clarity of principles* - the Paper suggests that the proposed classification boundary be based on the presence or absence of 'salary risk' (PV 5.43). If this is indeed the Board's intention, then we wonder whether the definition of a contribution-based promise could be more simply expressed by referring to this principle, particularly if the definition was to refer to the absence of 'future salary' risk. However, even a simple percentage of salary scheme (that currently meets the definition of a defined contribution plan under IAS 19) would appear to contain salary risk, as the cost to the employer will increase if and when the employee's salary increases. A career average type scheme would also appear to include salary risk.
- *Fair value-based measurement* - we have various concerns over the appropriateness of a fair value type measurement of contribution-based promises including the effects of own credit standing on the measurement.
- *Timing* - we would not wish the Board's further deliberations in this area to lead to delays in addressing what we regard as being the more pressing problems associated with IAS 19's deferral and smoothing mechanisms.

Accordingly, we recommend that any changes in this area are made as part of a longer-term project so as to prioritise the more pressing issue of eliminating the option to defer recognition of actuarial gains and losses.

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If you have any questions on our response, or wish us to amplify our comments, please contact our Executive Director of International Financial Reporting, Andrew Watchman (andrew.watchman@gtuk.com or telephone + 44 207 391 9510).

Yours sincerely,

Kenneth C. Sharp

Kenneth C Sharp
Global Leader - Assurance Services
Grant Thornton International

Invitations to comment questions

We have responded below only to those questions on which we have comments in addition to those in the main body of this letter.

Question 1 - Scope of the project

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?

As we outline in our response to question 14, we believe that significant improvements could be made in the short-term by introducing certain disclosures relating to mortality assumptions and the regulatory regime relating to benefit plans.

Question 2 - Recognition and presentation of defined benefit promises

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 are not aware of any such factors. The Paper appears to be a thorough examination of the issues within its scope.

Question 3 - Recognition and 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?

We think it is difficult to answer this question while broader issues of financial statement presentation remain unresolved. In the context of a short-term improvement project, however, we favour approach 3. This approach is closest to the current option in IAS 19.93A to recognise all actuarial gains and losses in the period in which they occur, outside profit or loss. Given that the Paper is intended to set out how the current standard can be changed in the short-term, we believe that an approach which is not radically different from the current approach is desirable.

Approach 3 can also be supported on the grounds that it presents items of income and expense with different levels of predictive value separately. It also has the advantage of a symmetrical treatment of interest cost on the defined benefit obligation and interest income on plan assets, presenting them both in profit or loss. In contrast, as the Paper notes, Approach 2 proposes that interest cost be presented in other comprehensive income which would be inconsistent with most other IFRSs.

Although we support Approach 3, we also see advantages in Approach 1 (recognising all changes in the defined benefit obligation and in the value of plan assets in profit or loss). This is the simplest approach in that it removes the need for potentially complex rules on the allocation of cost to profit or loss and other comprehensive income (which in turn give rise to a need for allocation of current and deferred taxation income and expense). As mentioned above however, on balance we believe it is more appropriate to wait until broader issues of financial statement presentation and the measurement of defined benefit obligations have been resolved before making a change of this magnitude.

(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?

As we have noted above, we believe that separation of the components of defined benefit cost into components that have more or less predictive value is important. Specifically, we agree with paragraph 28 of the Framework which notes "the predictive value of the income statement is enhanced if unusual, abnormal and infrequent items of income or expense are separately disclosed".

We therefore believe that some level of disaggregation is desirable. However, we believe that in setting this level of disaggregation, attention should be paid to cost-benefit considerations for the preparers of the accounts.

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

Other than this, we do not believe that there will be major difficulties in applying any of the presentation approaches. Approach 1 will be the simplest to apply while Approaches 2 and 3 are not radically different from the current approach under IAS 19.93A.

Question 4 - Recognition and 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?

We believe that the approaches suggested, together with an appropriate level of disclosure, should be capable of improving the reporting of post-employment benefits. We do not have any specific recommendations for their improvement at this time.

Question 5 - Definition of contribution-based promises

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?

We agree that the types of scheme identified in the Paper have given rise to problems in applying the current version of IAS 19.

We are also aware that it can be difficult to determine whether an 'insured scheme' is a defined benefit or a defined contribution plan under the current version of IAS 19, particularly so where the employer is purportedly 'fully insured' against benefits payable. Such schemes are discussed briefly in IAS 19.39 - 42. If the Board proceeds with the approach outlined in the Paper we suggest it might usefully reconsider whether the guidance on scheme classification in those paragraphs remains appropriate in the context of a revised 'boundary' between contribution-based promises and defined-benefit promises.

We are not aware of any other types of promise that we believe should be addressed.

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 do not have robust data on which to base a response but suspect that a large number of schemes may be affected.

In terms of the practical difficulties that would be presented, we note that the definition of contribution-based promises as currently worded is quite complex, and are likely to mean that careful consideration will need to be given to the elements of each individual plan.

Question 7 - Definition of contribution-based promises

Contribution-based promises, as defined in this paper, include promises that IAS 19 classifies as defined contribution plans. The Board does not intend this proposal to lead to significant changes in the accounting for most promises that meet the definition of defined contribution plans in IAS 19. Do the proposals achieve that goal? If not, why not?

We suggest that the proposals probably achieve that goal in situations when the periodic contribution is paid in by the end of the reporting period or very shortly afterwards.

We suggest however that the proposals on the measurement of a contribution-based promise need to be clarified in certain respects. The Paper suggests that a liability for a contribution-based promise should be measured at its fair value assuming the terms of the benefit do not change (PV 7.2). It also indicates (at PV 7.3) that the promise can be broken down into two components - a contribution amount and a promised return (if any).

We are not entirely clear on the reasoning behind or significance of the qualification 'assuming the terms of the benefit do not change'.

Secondly, it is not entirely obvious or intuitive that a 'contribution-based promise' comprises only the two components described in PV 7.3. To illustrate, a contractual obligation to pay (say) 5% of an employee's salary contains a third component - the conditional obligation to increase the monetary contribution amount as the employee's salary increases. This component clearly has some value. Although it seems clear that it is not the Board's intention to include this component in the fair value measurement, we suggest that this intention should be stated more directly.

Thirdly, the reference to 'contribution amount' in PV 7.3 and elsewhere could be expressed more precisely. This term is relatively straightforward for schemes in which the employer pays contributions to the employees' independent pension funds. Even in this case, however, a definition would be useful. This might be along the lines: 'contribution amount earned in the period in accordance with the terms of the promise'. In the case of a career average scheme, we assume that the measurement is intended to be based on the accumulated benefit at period end.

Question 8 - Recognition issues related to contribution-based promises

Chapter 6 discusses recognition issues related to contribution-based promises. The Board's preliminary views are summarised in paragraphs PV9–PV11. Do you have any comments on those preliminary views? If so, what are they?

We have no comments.

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.

Subject to our comments under Question 7, we believe that the usual arguments for and against fair value apply here.

(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 do not believe that an entity's own credit risk should be included in the measurement approach. We say this because we do not believe that this provides useful information for users of the accounts, and may in fact lead to users choosing to reverse out the entries relating to it which somewhat defeats the purpose of preparing the financial statements.

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?

We 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 in order to ensure that an obligation is accounted for consistently throughout its life.

We note however that measuring the liability for benefits in the payout and deferment phases in the same way as they are measured in the accumulation phase could lead in certain circumstances to the same ongoing obligation being measured in different ways (paragraph 8.6 in the Paper). We share the Board's concerns regarding the appropriateness of such an outcome, and we believe this provides further support for our view that the accounting for cash-balance type schemes should be addressed as part of a longer-term project rather than in the current project.

(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 are not aware of any such practical difficulties.

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 believe that it will be useful to present disaggregated information for those promises that are currently treated as defined benefit plans under IAS 19 but which would fall to be treated as contribution-based promises under the proposals. However, we suggest that such a requirement should be built around an objective and that there is no need for prescriptive rules. A simple requirement for a reconciliation of the carrying amount of the liability at the beginning and end of the period, showing the major movements, should be sufficient.

We note that such disaggregation should not be relevant for those contribution-based promises that are currently treated as defined contribution plans under IAS 19.

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?

Recognising all changes in the value of the liability for contribution-based promises in profit or and loss would have the advantage of simplicity. We believe however that mirroring the presentation of changes in the liability for defined benefit promises would be a better option.

We say this as it will lead to greater consistency between the accounting for defined benefit promises and those promises that are currently treated as defined benefit plans but will be treated as contribution-based promises under the proposals in the Paper. Furthermore, as those entities with promises that have previously been treated as defined benefit plans will be used to presenting information in this way it should not lead to any increase in costs for them, while the issue will not be relevant to promises that are treated as defined contribution plans under the current version of IAS 19.

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?

We believe that the proposal to recognise the 'higher of' option separately from the host defined benefit promise is in principle capable of providing higher quality information to readers of the accounts.

At the same time, however, we are concerned that carrying out this proposal will be a complicated exercise for some entities. Given that these schemes are currently being treated as defined benefit plans in their entirety, we question whether changing the requirements of the Standard in this way will lead to a sufficient improvement in financial reporting to be justified on cost-benefit grounds.

Question 14 - Other matters

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

We believe that significant improvements to the Standard could be made in the short-term by including disclosures on the mortality assumptions used in valuing defined benefit promises and the sensitivity of those assumptions to change. In relation to this suggestion, we note that IAS 19.120(n)(vi) currently requires material actuarial assumptions to be disclosed, but we believe it would be beneficial to explicitly require disclosure of the mortality assumptions used.

We also believe that it would be useful for entities to give a description of the regulatory regime governing their plans. We say this because the regulatory regime determines the actual cash commitment that an entity must meet, and the cash commitment may not necessarily correspond to the accounting entries reflected in the accounts. Similarly, the liability that must be met on the winding up of a scheme will usually be determined by the regulatory regime and may differ from the liability reported for accounting purposes on an ongoing basis. It is important for readers of the accounts to be aware of these differences.

Question 15 - Other matters

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

Please see the main body of this letter for our comments on this question.