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Sir David Tweedie
Chairman of the
International Accounting Standards Board
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Your reference
Our reference
Phone
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Date September 25th, 2008
Subject IASB Discussion Paper 'Preliminary Views on Amendments to IAS 19 Employee Benefits'

Dear Sir David,

We are pleased to have the opportunity to comment on the above mentioned Discussion Paper issued by the International Accounting Standards Board (IASB). In this letter we would like to set out our general comments on the Discussion Paper. The appendix of this letter provides you with our detailed comments on specific issues raised in the Discussion Paper.

We welcome the initiatives taken by the IASB in order to improve the comparability and transparency of pension accounting and believe that IAS 19 could benefit from the initiative and some of the proposed changes. However, we do have some major reservations on the proposed amendments of accounting for employee benefits. In summary, our key issues are as follows:

- We do not support an immediate and full recognition of the net-surplus or deficit whether this is on the balance sheet or within the income statement. We would prefer a revised corridor approach that applies the existing corridor for the impact of a change in financial assumptions and an "all through profit or loss approach" for a change of assumptions such as mortality.

- We do not support the new definition of contribution-based (CB) benefit promises. This to us seems to be an arbitary differentiation which places what are clear defined benefit promises into a different accounting regime. In addition, we do not agree with the proposed measurement approach of these CB benefits (fair value, inclusion of company's credit-risk, immediate recognition in income statement).
- In our view it would be sufficient to limit the scope of "troublesome" defined plans mainly to promises that are linked to an actual or notional return on assets. We would recommend pragmatic solutions for the accounting of these promises, such as for example using an option based approach.
- We strongly support the continued use of the expected return on assets (rather than actual returns) in order to reflect the financial impact of pension assets within the income statement. Extended information in the pension notes on the actual and expected return including a track record is recommended.

We would be pleased to discuss our comments with you at your convenience. If you have any questions, please feel free to contact:

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Yours sincerely,

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Enclosures

<u>Answers to the questions raised in the DP</u>

<u>Question 1</u>

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 believe the discussion paper goes too far in creating a new type of pension provision (contribution based “CB” plans). This is not a recognised definition anywhere else in the pension field. It would introduce more problems than it resolves. We would therefore propose that the Board considers a better method for the treatment of defined contribution plans with guaranteed or notional returns (please see to our reply to Question 5 for further details).

<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?

We would like to ask the board to (re-)consider two main issues with respect to preliminary view 2 (PV2; immediate recognition of all changes in the value of plan assets and in the post-employment benefit obligation in the financial statements in the period in which they occur):

1. Increased volatility on balance sheet and/or income statement;
2. Pension investment decisions should be driven by economic considerations rather than accounting rules.

Our fundamental remarks are linked to PV2, however, they do impact our comments to various other issues being discussed in the discussion paper (DP) as well.

1. (Re-) Consideration of accounting volatility

We do not believe that the immediate and full recognition of all changes resulting from the measurement of plan assets and post-employment benefit obligations provides necessary and useful information to the user of the financial statements – neither for the profit or loss statement (P&L) nor for the balance sheet (BS). We strongly support the arguments against this treatment (see item 2.5 of the DP). As such, we do not agree with the Board's PV 2. In our opinion the increased volatility – of both BS as well as P&L – has not been taken into account in a proper way.

Measurement and accounting of pension promises must take into account the very **long-term nature** of these items. We do not see a systematic lack of transparency caused by a corridor approach, as all necessary information to access the short-term view of the underlying net-liability, i.e. the difference between the defined benefit obligation (DBO) and Plan Assets, are provided within the existing pension notes.

In cases where a **short-term view** on pension liabilities appears appropriate (e.g. settlement cases such as M&A cases or for a potential transfer/buy-out) the necessary information is available or can quite easily be deducted by the figures already disclosed under current rules of IAS 19. However, the standard case for providing the promised benefits is still to continue the plan, and not to settle the existing plan liabilities immediately, i.e. a case where the long-term nature of the promise fully applies.

Under the "all through profit or loss approach", Deutsche Post World Net's (DPWN's) 2004 and 2005 reported EBIT figures would have reduced by approx. 20% and 30%, respectively. On the other side, 2006 and 2007 EBIT figures would have increased by approx. 10% and 40% (about 1.400m EUR), respectively. All gains/losses were mainly caused by a change of actuarial financial assumptions (discount rate, inflation rate). The cumulated net actuarial loss over that 4-year-period amounts to 100m EUR. By applying the corridor-approach of current IAS 19 in this 4-year-period, DPWN in total recognized actuarial losses amounting to approx. 150m EUR in the income statement (annual impact roughly 1% of reported EBIT), i.e. an amount that looks quite reasonable being compared with the cumulated loss of this 4-year-period and especially when being compared with the annual impacts under an "all through profit or loss approach". We strongly believe that this outcome underlines the long-term nature of pension provision which should be reflected in accounting and would thus, provide more useful, relevant and reliable information than the annual (or even quarterly) volatility of the "all through profit or loss approach" which in our opinion produces random-like results and leads to misleading accounting information.

JPMorgan provided an analysis for British Telecom's 2006/2007 results (research report from Sarah Deans (JPMorgan), dated 4 April 2008). According to this analysis, the reported net income would have increased by 52 % by applying the "all through profit or loss approach" (approach 1 proposed by the Board). Major German DAX companies would have reported significant fluctuations for their 2007 earnings, too.

All the above arguments are true for both the income statement and the balance sheet. However, due the law of large numbers, the relative impact on the balance sheet is limited compared to the impact on the income statement. In addition, the focus of investors is clearly on (short-term?) earnings. Thus, companies are typically more concerned on P&L-volatility than on BS-volatility. However, from a conceptual point of view we believe that both kinds of short-term volatility do not provide any additional relevant information to the reader of a financial statements. In contrast, we believe that at least the P&L-volatility would be a matter of future re-adjustments by analysts / rating agencies, as they most likely will focus on (real) ongoing earnings rather than to have earnings diluted by arbitrary short-term impacts.

2. (Re-) Consideration of pension investment decisions

Our main concern here is that if companies are forced to focus on a reduction of accounting volatility they may take investment decisions that may on the one hand reduce such accounting volatility, but on the other hand will increase economic costs in the long run. The investment decision process would then be dominated by accounting rather than economic considerations.

As pointed out above and as laid down in the conceptual framework of IFRS, accounting information must have predictive value. Thus, companies have to deliver quarterly and annual results that help users of the financial statements to evaluate past, present or future events. Increased P&L-volatility (e.g. resulting from the accounting for pensions) is contradictory to this. To a somewhat lesser extent companies are also concerned about balance sheet-volatility. However, given the fact that accounting rules force (or may force) companies to immediately realize these accounting volatilities, there is much pressure on the decision makers in order to avoid this accounting volatility and to take decisions concerning that pressure. These decisions may optimize (minimize) accounting volatility, but at higher economic costs.

Without doubt, (pension) investment decisions should be driven by economic considerations. Decisions that are economically wrong probably increase overall costs significantly. Over the last couple of years there was a clear change of investment and/or risk strategies by many companies. Besides individual well-founded considerations by each company, it is out of question that changes in accounting rules - starting with a new UK standard ("FRS 17 - Retirement benefits") being implemented at the beginning of this century - were a significant driver of this trend. We are concerned whether this trend will create the right economic environment to encourage entrepreneurship in the global economy.

In addition, there is an increasing "consulting pressure" coming from the financial industry using these volatility arguments in order to place new investment products (including Liability Driven Investment (LDI) approaches) that are expected to solve or partly solve these accounting issues, i.e. to limit volatility. However, we have considerable doubts with respect to the cost/benefit ratio of some of these new products / asset classes. In a recent Watson Wyatt publication ("Defining moments", April 2008) it is pointed out that average costs of pension investments have increased from 2002 to 2007 from 63bps to 119bps. Not surprisingly, this increase can be attributed to an increase of transaction costs and investment manager costs (whereas costs for consultants have slightly reduced). Watson Wyatt came to the conclusion that this is caused by an "exposure to more expensive asset classes". Whereas these asset classes already cause higher ongoing costs, they still have to prove that they will deliver the expected results in the long run – which must not be, but in many cases are, limited to reduction of (accounting) volatility.

The final step on the "risk reduction ladder" - again with respect to accounting volatility - is a pension buy-out, i.e. a transfer of liabilities and assets to an insurance company or to new buy-out companies. Over the last few years, a considerable buy-out industry has developed in the UK. Such a transfer of risk can be considered as a kind of ultimate reduction of risk and (accounting) volatility for still existing defined benefit plans. However, economically this would lead to the highest (expected) costs. At least in the past it was always a fair selling argument for corporate pension plans, that they can deliver pension benefits at a lower cost compared to funding via an external third party.

Our final remark here is that implementation of similar strategies by many companies (e.g. buying long-duration inflation-linked bonds) may result in serious distortions of the capital market. It can be argued that this has already happened. Thus, again trying to control these short-term volatility risks may increase long-term costs.

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?

(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?

As pointed out under Question 2, we do not support any of the three approaches as we believe that short-term balance sheet-volatility as well as income statement-volatility should be excluded from the financial statements. We recommend keeping an amended corridor approach (see our reply to Question 4).

In addition we find it rather difficult to decide on the three presentation approaches without knowing the direction the IASB is heading under its project on “Financial Statement Presentation”.

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?

As a pragmatic and well-approved solution in order to deal with our concerns about accounting volatility and investment decisions (see reply to Question 2) we recommend to make use of a modified corridor approach.

We agree with the DP that a distinction has to be made between the impact of a change of financial assumptions on the one hand (e.g. interest rate and difference between expected and real return on plans assets) and a change of more ”lasting” assumptions on the other hand (e.g. demographic assumptions like mortality). We believe that for the impact of any changes of financial assumptions a corridor approach should be applied (as these impacts will quite likely reverse over time). However, as it is quite unlikely that any impacts due to e.g. updated mortality assumptions will reverse over time, we propose to recognise them immediately and fully via P&L. In order to improve comparability between different companies, we suggest to make the revised corridor approach mandatory under IAS 19.

Additionally, although not supporting any of the OCI-approaches proposed in the Discussion Paper, we are missing a broader discussion of the arguments why a recycling of actuarial gains and losses from OCI into profit or loss is conceptually not pure and acceptable. Please note that also from this perspective, in our opinion, a corridor approach is superior to any OCI-approach.

We disagree with the Board’s PV 3 (entities should not divide the return on assets into an expected return and an actuarial gain or loss). We believe that sufficient reliable information is available to prove the appropriateness of expected return rates. Please be aware of the fact that in practice the management of pension funds - including funding decisions - is often based on the (long-term!) expected return on assets. Thus, these figures are often easily available and well-approved.

<u>Question 5</u>

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 disagree with the Board's preliminary view about the new categorization of post-employment benefit arrangements into defined benefit and "contribution-based promises" as well as the intended measurement attribute "fair value". We believe that current IAS 19 is straightforward with the definition of defined benefit and defined contribution plans and deals adequately with most promises. Thus, we do not see any reason to change the valuation and/or accounting method for many of the plans being in the focus of the DP.

However, we agree with the Board that there are some "troublesome plans" that would need short-term improvements in the accounting for post-employment benefits (i.e. already within phase 1 of the pension project). In our understanding, "troublesome plans" can be mainly limited to promises that depend upon, or are linked to, the return from an asset, from a group of assets or an index. Only these plans may face potential valuation / accounting difficulties. All other benefit promises mentioned in Chapter 5 and Appendix A of the DP - including career average plans and promises with a fixed return - do not raise measurement difficulties under the rules of current IAS 19 and should be excluded from the scope of the project. These "troublesome plans" should be valued with the fair value of the underlying or notional assets. In case of a fully funded benefit promise, the liability and asset amounts would be identical.

As far as a benefit promise contains a "higher of"-option (e.g. a guaranteed minimum return of 3% p.a.), the host benefit promise should be recognised as a regular Defined Benefit promise, i.e. by applying the PUC-method or by applying the method described in the preceding paragraph. In addition, the option should be valued and recognised at fair value (if appropriate by means of option pricing models).

In our opinion, the requirement to consider an entity's own credit risk for contribution-based promises, whereas for defined benefit promises a different discount rate has to be used (based on corporate bonds), is also questionable from a conceptual point of view. We do not see any economic reason that would justify different measurement attributes for these two types of benefit promises. As such, comparability among companies may suffer.

<u>Question 6</u>

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?

Deutsche Post World Net provides about 200 defined benefit plans in more than 20 countries worldwide. According to our initial analysis we expect that the majority of these Defined Benefit Plans (as well as the majority of the related DBO) would be reclassified as CB-Plans.

<u>Question 7</u>

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

Of the 14 examples of pension promises analysed in the Discussion Paper, six (Numbers 5,6,7,10,13and 14) would involve a switch from DB status to CB status. We believe that it is difficult to understand and explain why these types of promise require change, in particular why a career average salary plan should be treated differently from a final average pay plan from an accounting perspective, given that the risks to the sponsor are broadly the same.

<u>Question 8</u>

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

We have no further comments on PV 9 and PV 11 since we generally disagree with the new definition of contribution based promises which appears illogical and will have a dramatic impact on pension accounting in many countries, Germany included.

<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.

(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?

Please see to our reply to Question 5.

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 disagree with the Board’s preliminary views about the new definition of contribution-based promises and the intended measurement attribute ‘fair value’. We support the view that economically similar benefit promises (including pensions in payment) should be measured similarly.

Our recommendation to the Board is to focus on the “troublesome” plans (see our reply to Question 5). This would reduce the number of plans being affected by this project significantly. However, for the identified real “troublesome” plans it is worth to avoid the contentious issue addressed in this question.

<u>Question 11</u>

(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?

No further comments.

<u>Question 12</u>

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?

No further comments.

<u>Question 13</u>

(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?

No further comments.

<u>Question 14</u>

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

No further comments.

<u>Question 15</u>

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

No further comments.