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Sent via Electronic Mail To: CommentLetters@iasb.org.uk

Dear Anne:

On behalf of Standard & Poor's Ratings Services ("Ratings Services") we are writing to provide our comments regarding the IASB's Exposure Draft on its proposed amendments to IAS 19 Employee Benefits, "Actuarial Gains and Losses, Group Plans and Disclosures".

In our analytical work, the accounting for costs and obligations arising from defined benefit plans is a topic that, where these plans are material, requires significant adjustment of reported amounts, and beyond this, significant qualitative assessment of risks that cannot be adequately captured by financial amounts and ratios alone. Please see the attached commentary on the methodology applied for corporate issuers rated by Ratings Services. This methodology is applied where necessary to adjust reported amounts to what we believe more faithfully depicts the associated economics and risks. We understand that the proposed amendments to IAS 19 are limited in nature and that the proposed accounting treatment is discretionary rather than mandatory. As a consequence, in most circumstances, we will continue to apply our methodology in adjusting reported amounts.

We believe that there is a need for greater transparency in the reporting of defined benefit plan obligations and funding. Many of the proposed disclosures would be highly useful in our analytical work, particularly with respect to the breakdown of plan assets, estimates of future contribution payments (yet, a disclosure spanning a longer time horizon would be much more beneficial in providing insights about anticipated trends), and changes in plan assets and obligations during the year.

We view the proposed option to recognise actuarial gains and losses immediately in the balance sheet without including them in the income statement as a practical expedient that provides a transition approach into IFRS that may well be helpful to some companies. While we can accept it on this basis, we are concerned by specific additional aspects of the proposal such as prohibiting the recycling of amounts initially recorded in equity and not requiring the amounts recognised directly in equity to be displayed as a separate component of equity. These aspects of the proposal can, within the current accounting model, provide an opportunity for abuse. We are concerned also that the level of disclosure proposed will not provide analysts with adequate information. We describe these concerns in our response to Questions 3 and 4. Our suggestions also go some way toward reducing the potential for abuse.

We strongly encourage the IASB to add a project to its near-term agenda that would comprehensively look at the accounting for costs and obligations arising from defined benefit plans. We recommend that the aim of the project be to require a single model of accounting that would mandate the full recognition of assets, liabilities and costs and reduce the potential for abuse. In our view it is desirable that the project be conducted in parallel with other accounting standard setters such as the FASB to further improve international conformity of financial reporting.

We welcome the opportunity to provide our input and would be pleased to discuss our comments further with you or any member of the Board or staff. If you have any questions or require additional information, please contact Sue Harding, Managing Director and IFRS Working Group Chair, or Neri Bukspan, Managing Director and Chief Accountant.

Best regards,

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<u>Question 1 – Initial recognition of actuarial gains and losses</u>
IAS 19 requires actuarial gains and losses to be recognised in profit or loss, either in the period in which they occur or on a deferred basis. The Exposure Draft proposes that entities should also be allowed to recognise actuarial gains and losses as they occur, outside profit or loss, in a statement of recognised income and expense. Do you agree with the addition of this option? If not, why not?

While Standard & Poor's Rating Services supports the addition of this option, our support is in spite of, rather than related to, actuarial gains and losses being recognised outside of profit or loss under the added option. The addition of options generally detracts from the advantages gained by moving to what we still hope will become a more consistent platform of accounting practices applied by many of the companies whose creditworthiness we rate.

However, while clearly not preferring the addition of an option, we understand that it serves the purpose of allowing a practical approach to transition into IFRS for some companies. Additionally, the current version of IAS 19 already allows a vast range of options on the accounting for postretirement benefits, most of which already require adjustment to conform to our own analytical methodology.

We believe that the added option will encourage more companies to recognise actuarial gains and losses in the period in which they occur. This is consistent with our methodology which we believe provides a better accounting representation of the underlying position, rather than deferring a portion off balance sheet subject to the continuum of treatments that could be applied under a 'corridor' amortisation approach.

We believe it is appropriate to restrict the option which allows recognition of actuarial gains and losses outside profit and loss, for use only by those that fully recognise actuarial gains and losses in the period in which they occur. Additionally, we are aware of a number of companies that do plan to adopt this option assuming that it is included in a revised IAS 19.

Off balance sheet 'deferral'

The proposed approach represents a significant step toward the full balance sheet recognition of economic deficits that Ratings Services applies under its methodology for adjusting financial information. However, the proposed approach will still fall short in circumstances where there are unvested prior service costs as these amounts remain off balance sheet.

It is not clear why the IASB has chosen to disallow balance sheet recognition of such prior service costs. This approach would also appear to be inconsistent with paragraph 69 of IAS 19 which addresses the attribution of benefits to the period of service and indicates that 'employee service gives rise to an obligation under a defined benefit plan even if the benefits are conditional on future employment (in other words they are not vested).' The resulting balance sheet, while improved by full recognition of actuarial gains and losses, will still fail to reflect the full economic obligation determined on the basis of benefits owed on account of unvested past service costs.

Statement of Recognised Income and Expense

The proposed 'strings attached' for companies that choose to recognise actuarial gains and losses outside of profit or loss include a mandatory 'statement of recognised income and expense'. We are not convinced that the objective of the IASB to emphasize that actuarial gains and losses are elements of income and expense, and the presentation of a comprehensive statement of changes in equity, are mutually exclusive. Such a comprehensive statement of changes in equity would include items considered to be components of income and expense and transactions with shareholders (included in paragraph 97 of IAS 1).

A comprehensive statement of changes in equity that clearly identifies items considered to comprise recognised income or expense would adequately address the IASB's concerns while allowing all changes in equity to be presented in a single statement. While we believe a single statement could also meet the IASB's objectives, we expect all changes in equity will need to be disclosed in a transparent manner as called for by the proposed amendments, even if the relevant information is required to be disclosed separate places.

<u>Question 2 – Initial recognition of the effect of the limit on the amount of a surplus that can be recognised as an asset</u>

Paragraph 58(b) of IAS 19 limits the amount of a surplus that can be recognised as an asset to the present value of any economic benefits available to an entity in the form of refunds from the plan or reductions in future contributions to the plan (the asset ceiling). * The Exposure Draft proposes that entities that choose to recognise actuarial gains and losses as they occur, outside profit or loss in a statement of recognised income and expense, should also recognise the effect of the asset ceiling outside profit or loss in the same way, i.e. in a statement of recognised income and expense. Do you agree with the proposal? If not, why not?

*** The limit also includes unrecognised actuarial gains and losses and past service costs.**

Recognition of actuarial losses on balance sheet with a charge to equity potentially reduces the accounting asset permitted to be recognised under the limit test prescribed by the current version of IAS 19. However, if the same actuarial losses had not been included in the balance sheet, then the unrecognised amounts could be deferred as assets under the asset limit requirements. While this demonstrates the flawed logic that allows deferred costs being presented as an asset under the corridor method, we understand that this aspect of accounting is not being addressed at this stage.

Under the circumstances addressed by the proposed amendment, there would be no unrecognised actuarial gains or losses to be considered under the asset limit requirements. As a result, the balance sheet recognition of an asset relating to a surplus would be limited to the aggregate of economic benefits available to the entity including the present value of available refunds or reductions in future contributions, and the amount of unrecognised prior service cost. The asset limit concerns are consequently focused around the changes in prior service cost not causing illogical earnings effects.

As the proposal does not contemplate any change in the treatment of prior service cost generally (see our response to Question 1) it is unclear why the asset limit rules require a change to have all asset limit adjustments, which under the proposed option only relate to prior service costs, included in equity and not profit or loss. The proposal would appear to transfer to equity both 'real' changes resulting from changes in the value of economic benefits and changes stemming from increases and decreases in deferred costs recognised as assets under the asset limit rules as a result of unamortised prior service costs. The inclusion in retained earnings and prohibition on recycling would also appear to be inconsistent with (or at least complicated by) the amortization of prior service costs, the rules on which are also not changed under the proposal.

While we do not see the need for this proposed change, whether the change is made or not, Ratings Services will continue to adjust the reported profit or loss and balance sheet based on our existing methodology.

What is most important to our analytical assessment will be clear disclosure of the related amounts on the balance sheet, in profit or loss, and included in equity directly. With respect to balance sheet amounts, separate disclosure of asset amounts supported by benefits from the present value of refunds, benefits from the value of reductions in future contributions, and amounts supported by the deferral of costs (prior service costs generally and unrecognised actuarial gains and losses where the new option has not been applied) is not currently required but would help us (and we presume other analysts and other users) differentiate between inherently different asset types and economic value that may be realized over differing timeframes. With respect to income statement amounts, the separate disclosure of separate items included in the income statement and items included directly in equity called for by paragraph 120 (g) and (h) will be necessary for analysts to interpret reported amounts and adjust them where called for under our methodology.

Question 3 – Subsequent recognition of actuarial gains and losses

The Exposure Draft proposes that, when actuarial gains and losses are recognised outside profit or loss in a statement of recognised income and expense, they should not be recognised in profit or loss in a later period (i.e. they should not be recycled). Do you agree with this proposal? If not, why not?

Question 4 – Recognition within retained earnings

The Exposure Draft also proposes that, when actuarial gains and losses are recognised outside profit or loss in a statement of recognised income and expense, they should be recognised immediately in retained earnings, rather than recognised in separate component of equity and transferred to retained earnings in a later period. Do you agree with this proposal? If not, why not?

The IASB's Basis for Conclusions indicates that it is difficult to see a rational basis on which actuarial gains and losses could be recycled into profit or loss, and there is no rational basis for transfer from a separate category of equity into retained earnings. We agree as this follows from there being no rational basis for 'deferral' in the first place. However, our support for these aspects of the proposal (no recycling, no separate component of equity) is subject to addressing our significant concerns that the level of disclosure proposed will not provide analysts with adequate information.

We agree that amortisation will never provide a better reflection of economic activity during the period. However, the lack of recycling to the profit and loss could potentially provide some added incentive to companies to, at least initially, underestimate obligations or overstate assets as subsequent changes in estimates will, with respect to cumulative periods of service provided by plan participants, avoid earnings altogether. Disclosure of information about the dynamic nature of estimates, amounts and the nature of differences between estimates and actual results, and changes in assumptions may substantially alleviate such concerns.

If a company applies a corridor method, the cumulative amount of actuarial gains and losses not recognised in profit or loss is required to be disclosed. We believe that when the cumulative amount is included in the balance sheet under the proposed option, it should also be disclosed. We are concerned that the proposal as drafted could lead to even less transparency in this regard if such amounts are to be lost in retained earnings in the absence of disclosure.

With respect to appreciating the total amount of actuarial gains and losses that would be recognised directly in equity under the proposal, we also believe that the cumulative amount of differences between previous assumptions and what has actually occurred, and the cumulative changes in assumptions included directly in retained earnings should be disclosed This would help analysts assess the magnitude of such amounts escaping earnings from the transition date, and would go some way toward explaining the dynamics of such amounts, some of which can be expected to reverse, others of which cannot.

The proposal requires disclosure of 'experience adjustments' arising on plan liabilities and on plan assets for each of the past 5 years. While this is helpful, it is only part of the trend information helpful to the analysis of actuarial gains and losses. Disclosures should also be made of the affect on the obligation of changes in actuarial assumptions over this 5-year period. Differences between previous assumptions and what has actually occurred, and the changes in those assumptions, are obviously closely related and can be best understood in a joint context to begin to appreciate the estimated obligation and related experience adjustments, whether differences are addressed by adjustments to assumptions, and the dynamics of differences that are expected to reverse and those that are not.

Question 5 – Treatment of defined benefit plans for a group in the separate or individual financial statements of the entities in the group

(a) The Exposure Draft proposes an extension of the provisions in IAS 19 relating to multi-employer plans for use in the separate or individual financial statements of entities within a consolidated group that meet specified criteria. Do you agree with this proposal? If not, why not?

***(b)* The Exposure Draft sets out the criteria to be used to determine which entities within a consolidated group are entitled to use those provisions. Do you agree with the criteria? If not, why not?**

We understand this to be a limited option to allow defined contribution accounting where sufficient information is lacking and under circumstances the IASB deems the cost to exceed the benefit. As proposed, we understand the alternative to this limited option would be to apply defined benefit accounting based on an allocation of pooled plan amounts.

The circumstances referred to by the IASB generally relate to:

1. the entity being a parent or a wholly owned subsidiary of an ultimate or intermediate parent and that parent produces consolidated IFRS financial statements available for public use, and
2. the entity has no debt or equity instruments traded in a public market and is not in the process of issuing any class of instruments in a public market.

The split of public/non-public may not always serve as appropriate basis for less information to be provided. While the majority of entities rated by Ratings Services are traded in a public market, some are not, yet our need for adequate information is not diminished by this distinction. In such circumstances, it is not uncommon for us to request supplemental information from the company. We note that while the IASB's consideration of the cost benefit relationship for certain entities is not explained in detail, the Basis for Conclusions for

IAS 27 does suggest acceptance that users of financial statements often have, or can get access to, more information. While we confirm this is the case with respect to many of the companies we rate, we do not think the IASB should encourage reliance on this approach for users to obtain sufficient information as such information may not be available in all cases or to all users of the financial statements.

Rather than forcing a reasonable allocation, the proposal allows that in such circumstances, defined contribution accounting can be applied. However, a reasonable allocation made by the company itself should generally be more reliable than estimates made by outside parties undertaking to analyse the economic obligation of a member of a consolidated group. Accordingly, where material, we would likely request that such an allocation be made by the company even if not required by IFRS.

We suggest that in addition to requiring disclosure of the general defined-benefit nature of the plan, its principal provisions, and the reasons for the company's inability to provide more precise estimates, the Board require disclosure of the allocation methodology applied.

Question 6 – Disclosures

The Exposure Draft proposes additional disclosures that (a) provide information about trends in the assets and liabilities in the defined benefit plan and the assumptions underlying the components of the defined benefit cost and (b) bring the disclosures in IAS 19 closer to those required by the US standard SFAS 132 Employers' Disclosures about Pensions and Other Postretirement Benefits. Do you agree with the additional disclosures? If not, why not?

We support the additional disclosures. In particular, we have the following comments.

Changes in assets and obligations, funded/unfunded obligations

Disclosure of changes in assets and obligations by component is both appropriate and necessary to explain the causes for movements in assets and obligations. (While the reconciliation of recognised balance sheet amounts will be eliminated, we expect that with the information disclosed, this can be reconstructed by analysts if necessary. This cannot be said of the opposite (and current) situation as changes in the assets and obligations cannot be reconstructed based on current required disclosures.) The separate disclosure of obligations under wholly unfunded and wholly or partly funded plans also provides meaningful information as the funding profile of these plans is different.

Expected contributions

We note that the proposal includes disclosure of contributions expected to be paid to the plan during the next fiscal year. We agree that this should be disclosed on the basis of the company's best estimate. However, we are unclear on how the phrase 'as soon as it can reasonably be determined' would actually operate as there is generally no obligation to update financial statements once published.

Disclosure of expected contributions should be disaggregated into mandatory and discretionary components as this split contributes to the transparency of near term calls on cash. Additionally, we recommend the Board consider mandating disclosures of expected contributions beyond the next fiscal year, and an indication of whether such expected contributions are mandatory or discretionary. We believe that this information would be useful disclosure since contributions may escalate in subsequent periods as a result of delayed deficit funding features inherent in many pension systems which allow companies to close a funding-gap over several future periods.

Significant terms
We also support disclosure of significant terms used in the determination of the obligation. This would add to the transparency of obligation amounts, particularly where it is unclear how sensitive the obligation amount is to changes in disclosed assumptions or the effect of undisclosed assumptions and changes in such assumptions is unclear.

Sensitivity
In our analytic work, we often observe companies in the same industry with seemingly similar workforce demographics and benefits plan characteristics using different discount rates, and rates of compensation increase assumptions. It would be extremely helpful for users of financial statement to be given the effect on the benefit cost and benefit obligation of a one-percentage-point increase or decrease in these assumptions. We believe this information would be as useful and relevant for our analytic purposes as the proposed health care cost trend rate sensitivity information.

Plan assets
We also welcome the disclosure of categories of plan assets as different categories have inherently different risk profiles.

Other
We have also commented on 'experience adjustments' in response to Question 3.

<u>Question 7 – Further disclosures</u>
Do you believe that any other disclosures should be required, for example the following disclosures required by SFAS 132? If so, why?
(a) a narrative description of investment policies and strategies;
(b) the benefits expected to be paid in each of the next five fiscal years and in aggregate for the following five fiscal years; and
(c) an explanation of any significant change in plan liabilities or plan assets not otherwise apparent from other disclosures.
SFAS 132 also encourages disclosure of additional asset categories if that information is expected to be useful in understanding the risks associated with each asset category.

We note that the Basis for Conclusions does not provide an explanation of why the disclosures required by SFAS 132 and referred to in Question 7 of the proposed amendment were rejected by the IASB. The disclosures referred to in Question 7 do address topics that we find can be significant to our assessment of risks attached to defined benefit plans. Perhaps most significant is the disclosure of investment policies and strategies, which would enable users to gain further insights about relative prudence of plan investment strategies and performance against benchmarks both historically and prospectively. Further, consistent with the Board's objective in introducing the reconciliation for plan assets and liabilities in the first place, we believe an explanation of any significant change in them not otherwise apparent from other disclosures should be mandated. If relevant information is not included in the financial statements or supplemental disclosure, and we believe the point is significant in a particular situation, we generally would request (and be in a position to receive) such information from company management. However, as we have noted elsewhere, we encourage the IASB to require disclosure of such significant information within the financial statements rather than placing reliance on the ability of users to access such information.

Items referred to in responding to other questions above

In responding to questions 1-6, we have described the need for the following additional disclosures:

- Question 2 – with respect to balance sheet amounts, separate disclosure of asset amounts supported by benefits from the present value of refunds, the value of reductions in future contributions, and amounts supported by the deferral of costs.
- Question 3 and 4 - cumulative amount of actuarial gains and losses not recognised in profit or loss.
- Question 3 and 4 - cumulative amount of experience differences on assets and obligations, and the cumulative changes in assumptions included directly in retained earnings
- Question 3 and 4 – with respect to plan obligations, changes in actuarial assumptions for each of the past 5 years.
- Question 6 – with regard to the next fiscal year, the separate amounts of expected mandatory contributions and expected discretionary contributions.
- Question 6 - expected contributions beyond the next fiscal year, whether mandatory or discretionary.

Classification – Income Statement

One of the most surprising aspects of the IFRS accounting for defined benefit obligations is the extreme flexibility under IAS 19 of classifying the various components charged to profit or loss. While the existing disclosure requirement in paragraph 120(g) seems to call for disclosure of the income statement line item in which each component of the total expense for defined benefit plans is included, the information disclosed by companies can at times be unclear, requiring confirmation or clarification. While this may be more a matter for those parties involved in compliance issues, we would ask that the IASB consider whether this requirement can potentially be further clarified.

Classification – Cash Flow Statement

Much of our analytical work focuses on cash flows. We generally assume that the benefit-related cash flows are included under operating activities in the statement of cash flows, but this does not appear to be an explicit requirement. When it comes to classification of amounts on the cash flow statement, we would either like to see this classification information disclosed by companies or the requirements for classification made explicit under IFRS.

Surplus and recoverability

Disclosure of more than one plan in aggregate (or more to the point on a net basis) can disguise separate surpluses and deficits. This can be a significant concern where such surpluses may not represent economic value that the company is able to access. We encourage the IASB to consider separate disclosure of surplus and deficit amounts.

Additionally, and potentially more significantly, we encourage the IASB to require disclosure of asset limit information on the basis of evaluating the total surplus amount of any plan for which the plan assets exceed obligations under the asset limit requirements. Currently, disclosure and application of the asset limit rules only applies when the accounting method used would, in the absence of the asset limit requirement, have resulted in a higher asset amount on the balance sheet. In applying the asset limit requirements to all surplus amounts, only recoverability based on the present value of economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan would be relevant.

Assumptions relevant to the income statement and obligations

We are concerned that certain aspects of the disclosure requirements may confuse readers. Paragraph 120(m) requires disclosure of 'principal actuarial assumptions used as at the balance sheet date'. Apart from subsection (ii), we interpret this to require disclosure of those assumptions that have been used in valuing the obligation and that would also be applied in determining amounts recognised in earnings in the following period. As for subsection (ii) which addresses the expected rates of return on any plan assets for the periods presented in the financial statements we suggest removing it from (m) as it refers to past period profit or loss, and adding it to (i) which would then address expected rates of return applied historically and at (prospectively from) the balance sheet date.

Transparency of assumptions would call for disclosure of:

1. assumptions applied during the period in determining amounts charged/credited to profit or loss,
2. assumptions applied in determining the obligation at the balance sheet date, and
3. assumptions to be applied in the following period in determining amounts charged/credited to profit or loss.

While (m) seems to explicitly address the last two of these, we are unclear as to whether the first is required. While in many cases it may be appropriate to assume the prior period balance sheet date disclosures address this, there may be cases where this is not appropriate and no disclosure would be made. This could be addressed either by an explicit requirement to disclose assumptions used in determining amounts recognised in profit or loss or a separate disclosure of assumptions applied during the period only if they differ from those disclosed at the prior balance sheet date.

Related deferred taxes

Payment of defined benefit plan obligations often provides a tax shield to the company either at the time of funding or at the time benefits are ultimately paid. As a result, we seek in our analysis to appropriately factor in the related tax benefits. While in many cases assumption of the marginal tax rate is appropriate, there are cases where this may not be an appropriate assumption. We encourage the Board to consider requiring disclosure that would clearly indicate both the associated deferred tax amounts included in the financial statements (balance sheet and profit or loss) and the appropriate amount associated with the difference between the present value of benefit obligations and the fair value of plan assets (as under FRS 17).

Interim financial statements

The value of plan assets and plan obligations can change significantly from year to year and for a variety of reasons. However, whether disclosure of the nature and amount of significant changes occurring within an interim period is required, including interim portfolio performance reporting, seems to be unclear. Paragraph 16(c) of IAS 34 requires disclosure of the nature and amounts of recorded amounts that are unusual, but we believe that all significant changes, whether recorded in the balance sheet or not, should be disclosed.