30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410   Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org   Website: www.iasb.org

**International Accounting Standards Board**



**INFORMATION FOR OBSERVERS**

**Board Meeting:** **November 2008, London**

**Project:** **Post-employment Benefits**

**Subject:** **Preliminary Views on Amendments to IAS 19 *Employee Benefits* - Initial comment letter analysis (Agenda paper 6)**

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## Objective of this paper

1. The comment period for the Board's discussion paper *Preliminary Views on Amendments to IAS 19* Employee Benefits ended on 26 September 2008. The purpose of this paper is to summarise, in very broad terms, the 149 responses we received as at 31 October 2008. An analysis of those comment letters by constituent type and geographical region is included as Appendix A.

2. In addition to a review of the comment letters received, the staff undertook an intensive communications exercise for this project, beginning with a live webcast and Q&A on the date of publication and followed up with meetings, talks, Q&As, conferences, webcasts, conference calls, articles and email correspondence with a wide range of constituents. These involved preparers, users, actuaries, auditors and other pensions professionals as well as the Employee Benefits Working Group. The minutes of the Employee Benefits Working Group are attached in Appendix B *(omitted from observer notes)*. This paper reflects both formal and informal feedback received.

3. At this meeting, we will:

    a. provide board members with an overview of the main issues raised by respondents. We plan to provide more detailed analysis of the responses to the questions in the discussion paper as the relevant issues are addressed at subsequent meetings.

    b. ask the Board if there are any areas that they would like the staff to develop further.

4. This paper does not provide a quantitative review of the comments received or attribute comments to individual respondents. This paper also does not contain staff views or recommendations. Those will be presented to the boards at subsequent meetings.

## Summary of significant comments and issues

5. The main issues identified in the comment letters are:

    a. Many respondents indicate their expectation that a comprehensive second phase of amendments to IAS 19 will follow soon after this project. Most agree that a comprehensive project is necessary. However, some advocate deferring the comprehensive project until the Board's projects on fair value measurement, financial statement presentation and the conceptual framework are completed. Others believe the Board should start its comprehensive review now.

    b. Most respondents were supportive of the Board's preliminary view that all changes in the defined benefit obligation and in plan assets should be recognised in the period in which they occur. However, there were diverse views on presentation. Many express the view that the Board should not decide on the presentation of pension costs until the financial statement presentation project is finalised, or at least further developed, to prevent inconsistencies between the two projects. Comments on recognition and presentation are discussed further in paragraphs 14-24.

    c. Many constituents do not support the Board's proposal to eliminate the requirement to calculate and present an expected return in profit or loss. They do not find the Board's arguments convincing and argue that the expected return on assets conveys decision useful information (see paragraph 18).

d. Respondents were critical of all the presentation approaches set out in the discussion paper. Some respondents suggested other approaches, in particular:

    i. requiring the existing option in IAS 19 to recognise actuarial gains and losses in other comprehensive income ("the existing OCI approach").

    ii. requiring the recognition of actuarial gains and losses in other comprehensive income, with recycling ("the FASB approach").

e. Most respondents were critical about the Board's proposals for contribution-based promises. Some state that the proposals are more problematic than the current requirements. In particular:

    i. The scope of contribution-based promises, as defined in the discussion paper, is too wide. The Board should restrict the scope to promises that are problematic to account for using IAS 19.

    ii. The measurement proposed represents a fundamental change in measurement for many post-employment benefit plans. It would preferable, and possible, to deal with the troublesome promises within the existing framework of IAS 19.

    Comments on contribution-based promises are discussed further in paragraphs 25-43.

f. Most respondents did not comment on the Board's proposals for the accounting for an option to receive the higher of a defined benefit or contribution-based promise. Many of those who commented criticized the proposals.

    i. Some noted difficulties in measuring the fair value of the higher of option because the underlying promise is measured using the projected unit credit method, which considers only one outcome.

ii. Some would prefer a simpler measure, for example intrinsic value, which would account only for the outcome that was the higher at the reporting date. They argue that the benefits of measuring the option at fair value would not outweigh the time and effort expended.

However, others argue that the proposed approach is at least better than the current approach which does not account for the guarantee. We intend to analyse the issues relating to accounting for a higher of option in a later paper, after the Board has discussed the definition and measurement of contribution-based promises in more depth

g. Constituents would welcome an overhaul of the disclosure requirements. Such an overhaul should not add to the already extensive requirements and should be based on principles (see paragraph 44).

## Relationship to tech plan

6. The tech plan presented in October 2008 did not envisage Board discussion of the comment letters until December 2008. Presenting this initial comment letter analysis a month early should facilitate more productive discussions at future meetings. We also hope that it will assist Board members if they receive questions about the response to the discussion paper.

## Next steps

7. At the December 2008 meeting, we propose to bring to the Board a paper that

a. discuss the scope of a future exposure draft to be developed from the discussion paper; and

b. presents and discusses the comments on the recognition and presentation of defined benefit promises.

## Overview of comments in comment letters

### *Scope*

8. Question 1 asked whether constituents agree with the scope of the project and, in particular, whether the most urgent issues in practice have been identified.

9. While some constituents argued that the scope of the discussion paper is already too wide and that no more issues should be added, some suggested additional issues.

10. Some of the additional issues that constituents have asked us to address are clearly beyond the scope of a project to be finished by 2011. These include some matters that the Board has explicitly stated it will not address in this project, for example, consideration of gross rather than net presentation of pension assets and liabilities, and revising the measurement of the defined benefit obligation. Other issues are more in the nature of clarification or improvements, similar to the type of issues that might be considered in annual improvements.

11. We propose that we analyse these issues and bring a paper to a future meeting that will:

    a. set out a comprehensive list of issues raised by respondents

    b. provide recommendations on which issues should not be considered by the Board as part of this project

    c. provide recommendations on how the issues we think could be dealt with in this project should be addressed (a "tidying-up" exercise).

12. The responses to Question 1 also included general comments on the scope of the discussion paper. Most constituents are supportive of the Board performing some kind of review of the accounting for pensions. However, most do not agree with the approach that the Board proposed in the discussion paper.

13. In particular, constituents argued:

    a. Piecemeal changes in the accounting for pensions are onerous on preparers and confusing for users. Most respondents expect that the Board will undertake a comprehensive review of post-employment benefits once this project is completed. Some argue that the Board should avoid a two-phase approach and perform the comprehensive review now, even if it takes slightly longer. Others argue that such a comprehensive review would not be possible until the Board has completed other projects such as fair value measurement, financial statement presentation, insurance and the conceptual framework.

b. While IAS 19 has limitations, investors have gained an understanding of its principles and some short-comings could be addressed by additional supplementary disclosures. A fundamental change now in the measurement of some post-employment benefits would not add to transparency in the short-term.

c. A serious flaw in IAS 19 is the lack of comparability generated by the number of options for deferred recognition. Some argue that, for a first phase, it is a sufficiently beneficial aim to reduce the number of options for when gains and losses are recognized. Thus, they believe that the Board need only require immediate recognition of all gains and losses in the statement of financial position, and leave the existing options in IAS 19 for presenting changes in those gains and losses either in profit or loss or in other comprehensive income. Others support the Board’s view that it is also necessary to eliminate presentation options, and agree that the presentation of changes in the defined benefit obligation and plan assets can be dealt with in this project.

d. Many comment letters do not comment in detail on the proposals relating to contribution-based promises because they disagree with the fundamental proposal of creating a new category of promises either at this stage in a short-term project, or at all. They state that the Board should not amend the accounting for those promises that are not problematic to account for using IAS 19. Some also believe that the troublesome promises would be better dealt with within the existing framework of a defined benefit plan. (see paragraphs 25-43)

e. Some disagree with the specific proposals on the measurement of contribution-based promises but agree with the overall scope of the project on the grounds that the problems with the accounting for contribution-based promises have been outstanding for years, and there is a need for clear guidance.

### *Recognition of defined benefit promises*

14. PV2- PV4 of the discussion paper set out the following preliminary views:

    PV2 Entities should recognise 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.

    PV3 Entities should not divide the return on assets into an expected return and an actuarial gain or loss

    PV4 Entities should recognise unvested past service cost in the period of a plan amendment.

15. Question 2 asked for factors that would cause the Board to reconsider these preliminary views. The comments received are summarised below.

*Immediate recognition*

16. A substantial majority of respondents agreed with PV2 . This probably reflects the fact that some countries—including the UK and the US—have already amended their pensions standards to require immediate recognition of pension liabilities in the statement of financial position.

17. A small number of respondents disagree with PV2. This is because they think that pensions are long term liabilities and so the volatility from year to year should be treated differently from the volatility of short term items.

*Expected return*

18. Many respondents disagree that entities should not divide the actual return on assets into an expected return and an actuarial gain or loss. They are critical of the discussion paper's argument that the subjectivity inherent in determining the expected rate of return provides entities with an opportunity to manipulate profit or loss. They argue:

    a. Concerns about subjectivity and anti-abuse are not consistent with writing principles-based standards. Abuse is a problem for regulators and auditors and should not be the basis for standard-setting.

    b. Concerns about the appropriateness of the rates chosen should be dealt with by better policing, stronger guidance and enhanced disclosure, eg of sensitivities and historical record. Sufficient reliable information is available to support estimates of expected return rates.

c. The Board is willing to accept much greater subjectivity in other areas, including the estimation of fair value assuming the benefit does not change for contribution-based promises.

d. The Board cannot eliminate the potential for abuse by eliminating the expected return on assets. There is equal subjectivity, and possibly greater effect, in other assumptions inherent in determining the defined benefit obligation.

e. In practice, the management of pension funds, including funding decisions, is often based on the long-term expected return on assets.

*Unvested past service cost*

19. Most respondents agree with the Board's conclusions on unvested past service cost (PV4), though some argue that it is not appropriate to make this change in a short-term project, particularly since it is inconsistent with IFRS 2.

## *Presentation approaches for defined benefit promises*

20. The discussion paper set out alternative approaches for the presentation of components of the defined benefit cost and analyses the relative merits of each approach. Questions 3 and 4 asked:

> **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?
>
> **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?

21. The response to question 3(a) varied with the nature and function of the response group.

    a. User groups largely preferred option 1 on the grounds that it presented all the changes in the same place. They argue that it provides users with needed transparency of the impacts of the risks and rewards associated with the way a plan is structured and funded. Although remeasurements have limited predictive value, the effect of remeasurements gives information about the risks and results of any risk management strategies the sponsor may or may not employ. However, many argue that if approach 1 is applied, then a different presentation within profit or loss is needed to identify components that do not relate to the core business. Thus, they argue that users need a clear split between operating and financing components and possibly remeasurements because the latter two do not relate to the core business.

b. A small minority of respondents preferred the simplicity of approach 2 but many reject this approach on the grounds that interest cost is a financing item and should be shown in profit or loss.

c. Preparers and auditors largely prefer approach 3 on the grounds that some items of pension expense have a different predictive value and so should be presented in other comprehensive income. Many who prefer approach 3 believe that the same rate should be used for both interest income and interest expense in order to present the net interest on a surplus or deficit. Thus, most of those who prefer approach 3 opted for calculating the imputed return at the implied rate on high quality bond yields. However, others are concerned that there would be a period of education and confusion amongst users until any new definition of “interest income on scheme assets” is understood. There was also significant support for continuing to use the expected return on assets to estimate interest income on plan assets.

22. Many respondents also suggested other approaches to presentation. These included

a. Require entities to adopt the option in IAS 19 to recognise actuarial gains and losses in other comprehensive income (“the existing OCI approach”). The Board rejected this approach in the discussion paper because it is not consistent with its preliminary view that expected return on assets should be eliminated, but many respondents disagree with that view (see paragraph 18).

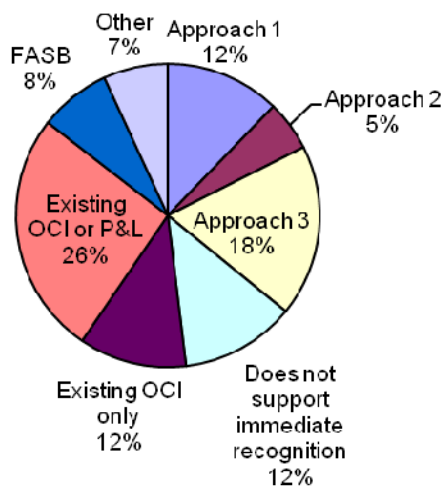
b. Recognising actuarial gains and losses in other comprehensive income, with recycling (“the FASB approach”).

c. Retaining two options currently in IAS 19, ie recognise immediately all actuarial gains and losses in profit or loss, or recognise immediately all actuarial gains and losses in other comprehensive income, pending completion of the financial statement presentation project.

d. A variation of approach 2 in which only the service cost, and not changes in service costs caused by changes in assumptions other than the discount rate is recognised in profit or loss.

23. The following chart indicates the level of support for each of these approaches.

Figure 1: Respondent support for presentation approaches




24. Common themes coming through the discussion of the three approaches included:

a. Pension cost includes operating, financing and other components. Some of those components are associated with workforce growth trends (eg service cost), while others result from broader economic factors (eg interest cost); some are within the control of the entity while others may not be. Investors regard these components as having different natures and different predictive characteristics. Footnote disclosure is not an adequate compensation for the commingling of the components in profit or loss.

b. It is important to have consistency between this project and the conclusions reached in the financial statement presentation project. Many expressed a view that no new presentation should be developed for pension costs until the financial statements presentation project is further developed or finalised. In the meantime, they suggested using the options already in IAS 19 of recognising all actuarial gains and losses immediately either in profit or loss or in other comprehensive income.  In addition, questions have been raised about the cohesiveness principle and how it might apply to pensions reporting.

c. Some actuarial firms comment that the Board's arguments about immediate recognition of changes in pension liabilities and plan assets do not take account of the fact that pension assets and liabilities are accounted for at current value, while many other assets and liabilities are not. The effect is that pension assets and liabilities appear more risky than other comparable long term assets and liabilities. Until all corporate assets and liabilities are measured at current value, the illusion of risk that results from the different treatment of pension assets and liabilities is not a faithful representation. Accordingly, it is appropriate that special consideration should be given to the presentation of the changes in pension assets and liabilities.

d. The Board has expressed its intention to converge with the US in the future. In the meantime, it is perverse to diverge significantly from the recent SFAS 158. If the Board does not decide to adopt a similar approach to SFAS 158, then at the very least, it should not increase divergence.

# Contribution-based promises

## *Definition and scope*

25. The discussion paper defined a new category of contribution-based promises to capture those promises for which the measurement requirements of IAS 19 are difficult to apply. Question 5 asked whether the definition captured the right promises to be addressed in this project.

26. Most constituents agree that the Board should amend the accounting for some plans that meet the proposed definition of contribution-based promises. However, most also think that the definition encompasses far too many plans. In particular:

    a. Some promises are not troublesome to account for in accordance with IAS 19 and it is not appropriate to change a well-understood methodology in a short-term project. An example would be a promise in which the benefit includes a fixed return on contributions.

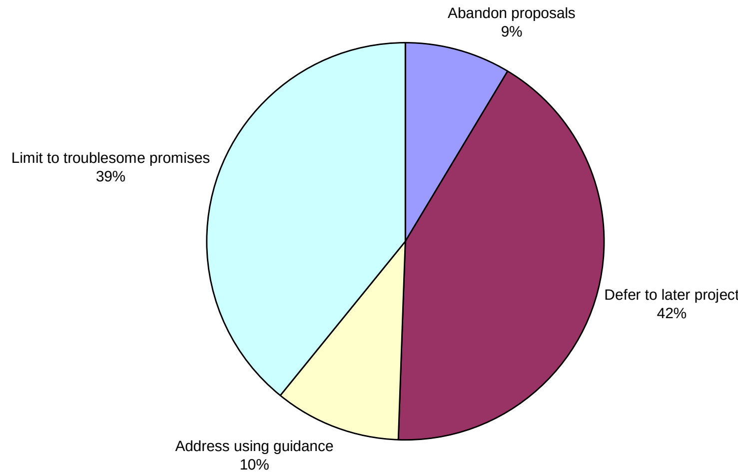
    b. Some promises are economically similar to defined benefit plans, in particular career average plans with long averaging periods. It is not appropriate to apply such different accounting to promises which are so similar.

    c. The distinction between promises in IAS 19 is based on risk. The proposals in the discussion paper put together in the contribution-based category promises with risks that are very similar to defined benefit promises and those whose risks are more similar to financial instruments. As a result, the demarcation is unclear and cannot be readily understood.

    d. It is difficult to determine the fair value effect of demographic risk. All promises that include demographic risk should be measured using the projected unit credit method.

27. Figure 2 illustrates the range of respondent views about how the Board should address contribution-based promises.

Figure 2: Respondent proposals for contribution-based promises




28. Some respondents state that the Board should abandon altogether its proposals to address the accounting for troublesome plans. Others think that the Board should defer developing proposals until it can do so comprehensively for all post-employment benefit promises. However, most agree that it is necessary for the Board to address at least some of the troublesome promises in this project.

29. Of those that agree the Board should address troublesome promises in this project, most state that the Board should restrict its amendments to a very narrow class of promise, for example, promises that are linked to the actual return on specified assets with no guaranteed minimum return. Others believe that the problems that the Board is trying to solve could be addressed by guidance on how to apply the existing requirements of IAS 19, rather than creating a new category of promises with a fundamentally different measurement basis.

30. In addition, many respondents raise issues on the detail of how to apply the definition of a contribution-based promise. For example:

    a. The definition relies on the nature of the benefit promise during the accumulation phase. However, it is not clear what the treatment should be if a plan is closed to future accrual (and future salary increases).

    b. Should the existence of death and disability benefits provided in the same plan as contribution-based benefits affect the classification?

c. Does the definition include benefit promises based on revaluations to be set by government in the future?

d. Does the definition include benefit promises based on points that are awarded on a basis other than salary, for example performance or negotiation?

e. Does it include benefit promises based on a fixed amount per year of service where that fixed amount is subject to annual renegotiation?

f. Does it include non-pension long term benefits such as long-term disability, sabbaticals, long service bonuses and jubilee benefits?

## Extent of change

31. At the start of the project, the staff expected that the contribution-based promise proposals would affect only a limited number of promises. Question 6 asked how many promises were affected by the proposals.

32. It is clear that many more plans are affected than was originally envisaged. We were already aware of this when we published the discussion paper. Estimates given by respondents include:

    a. A majority of German plans. At present, 70% of German plans are defined benefit and 30% defined contribution. Under the proposals, 70% would become contribution-based.

    b. All cash balance plans in Switzerland and Belgium, depending on the classification of promises of benefits with a revaluation set by government.

    c. Most plans in the Netherlands. Career average or revalued career average plans have been common in the Netherlands for many years and traditional final salary plans are increasingly incorporating a cap on pensionable salary that makes the plan appear more like a fixed or revalued accrual plan for high earners.

    d. One-half of all defined benefit registered plans in Canada are career-average earnings plans and flat-dollar benefit plans, and would be reclassified as contribution-based.

e. Half the plans in the US. One comment letter claims that about 20% of Fortune 500 US companies operate cash balance plans.

f. Nearly 10% of companies in the UK. Respondents commented that such plans were becoming more common.

### Defined contribution plans

33. The Board stated its expectation that the accounting for most defined contribution promises would not change as a result of being re-classified as contribution-based. Question 7 asked whether that is true. Most constituents agreed. However, some continue to see a benefit in having a clearly specified separate category of promises for which there is no risk to the employer.

## *Recognition issues*

34. Chapter 6 of the discussion paper discussed the following preliminary views:

PV9 An entity should recognise both vested and unvested contribution-based promises as a liability

PV10 An entity should allocate the benefits earned under a contribution-based promise to periods of service in accordance with the benefit formula

PV11 There should be no requirement to recognise an addition amount determined by the benefit that an employer would have to pay when an employee leaves employment immediately after the reporting date.

35. There were relatively few comments disagreeing with these preliminary views. The main issue raised is that there would be different attribution requirements for defined benefit and contribution–based promises, even though there may be little difference in the promises. This is primarily an issue that arises from the scope. Almost all those who raised this issue were also concerned about the inconsistency between the measurement of contribution based and defined benefit promises. Until a consistent treatment of all defined benefit promises is developed in a longer term project, those respondents opposed creating a new category of promises and treating them differently from defined benefit promises, or advocated restricting the number of promises affected.

### *Measurement*

36. Questions 9 and 10 ask about the Board's proposals for the measurement of contribution-based promises, including measurement in the payout and deferment phases. The Board's preliminary view is that entities should measure the liability for a contribution-based promise at fair value assuming the terms of the benefit promise do not change.

37. A small minority agree that the appropriate measurement method for contribution-based promises is *fair value assuming the terms of the benefit promise do not change*. However, most disagreed for the following main reasons:

    a. They disagree that credit risk should be included in the measure of any liability.

    b. While they agree that credit risk is relevant for certain types of benefit promises that are very similar to financial derivatives, they argue it is too subjective. Therefore they would prefer a consistent discount rate to be specified.

    c. They believe the measure of a post-employment benefit liability should not incorporate the effect of credit risk because the entity may be able to reduce even past service portions of benefits in some circumstances. They also argue it is illogical to incorporate credit risk in the measure of the liability without also incorporating possibility of changing benefit.

    d. They disagree that two different discount rates (risk-free for contribution based promises and AA for defined benefit promises) would apply to post-employment benefit promises that are very similar economically, such as career average and some averaged-final salary promises.

    e. They think it would be very difficult to determine the demographic risk factor ie the risk that the demographic assumptions used are incorrect.

38. Other issues raised about measurement at fair value assuming the benefit promise does not change are:

a. More guidance is needed on how to determine the risk adjustments needed to calculate fair value assuming the benefit promise does not change. For instance, some note that in a plan with shared assets, it would be necessary to fair value the defined benefit promise in order to determine the relevant credit risk for contribution-based promises.

b. Where the benefits in a plan were originally based on final salary, but are now based on career average salary, it would be difficult to separate the benefits between those accrued as final salary benefits and those accrued as contribution-based benefits. There is no obvious basis for the allocation of assets between the final salary and career average parts of such a plan. This would also affect the presentation of expense.

39. Some respondents think that instead of creating a new measurement basis for a new category of plans, the Board should modify the requirements by specifying how to apply the projected unit credit methodology for the troublesome plans.

40. Many disagree with the view that the liability for benefits in the payment and deferment phases should be measured in the same way as they are in the accumulation phase because this could result in the same liability being measured in different ways depending on the way it was accumulated. The way in which a benefit is accumulated is not an economic difference in the liability to be measured. However, they do not see any additional difficulty in measuring the liability for a contribution-based promise during the payout phase compared to the accumulation phase.

41. We intend to bring a detailed analysis of the comments relating to measurement, including a discussion of any alternative measurement method proposed by respondents to a future meeting.

## *Other matters relating to contribution-based promises*

42. The remaining questions in the discussion paper dealt with the following matters:

Question 11: disaggregation of information about changes in the liability for contribution-based promises

Question 12: presentation of changes in the liability for contribution-based promises

Question 13: the accounting for promises with a higher of option

43. We will not discuss the issues raised in response to questions 11-13 until the Board has discussed the definition and measurement of contribution-based promises in more depth.

## *Disclosures*

44. The Board stated its intention to review the disclosures required for post-employment benefit promises at a later stage of this project. Question 14 asked for comments on this review. The main comments are that the disclosures:

   a. should not be too onerous. Thus a review should encompass existing disclosures, and not merely add to those already in IAS 19.

   b. should reflect a principle-based approach, perhaps along the lines of IFRS 7.

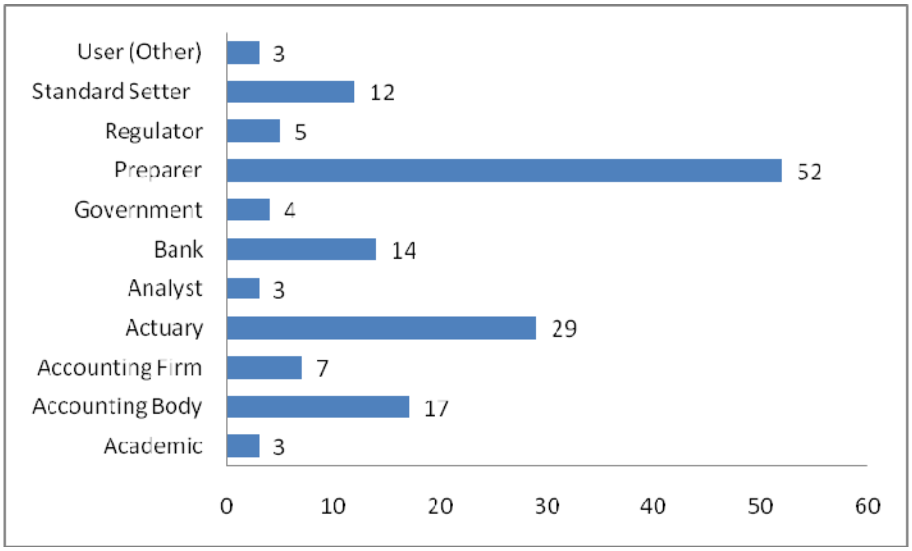
   c. should make more use of sensitivity analysis for the main assumptions.

   d. should be based on best practice around the world, in particular the UK ASB Reporting Statement *Retirement Benefits: Disclosures*, the US SFAS 158 *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* and the disclosures developed in the PAAinE's discussion paper *The Financial Reporting of Pensions*.

## Appendix A: Analysis of comment letters by type and region

149 comment letters were received as at 31 October 2008

### *By type of constituent*




### *By geographic region*