



*Consulting*

Your ref:  
Our ref: ABC\02-10\IAS Board2

Carnegie House, 21 Peterborough Road  
Harrow, Middlesex HA1 2AJ  
tel: 020 8864 9966  
fax: 020 8422 0760

International Accounting Standards Board  
30 Cannon Street  
London  
EC4M 6XH  
United Kingdom

30 October 2002

Dear Sirs

**First-time application of International Financial Reporting Standards (Employee Benefits)**

Based on the "Invitation to comment" to "Exposure Draft July 2002", we would like to set out some considerations with respect to the proposed abolition of deferred recognition of a transition gain or loss resulting from first-time application of IAS19 Employee Benefits (see par. 22 of the Exposure Draft).

In this respect it would be an "other comment on the Exposure Draft" as requested in Question 4.

Our considerations relate to the possible consequences of the proposed change on the reporting entity as such and on financial markets as a whole, as well as to the principles and qualitative characteristics laid down in the Framework for the Preparation and Presentation of Financial Statements.

Given these considerations, we would suggest that the Board should consider not removing the option of deferred recognition.

We suggest the board to consider:

1. Fast recognition (e.g. not more than 5 years) of an underfunded position in terms of assets versus the current benefit obligation "CBO"; where CBO equals the benefit obligation, disregarding the effects of any future events other than the "passage of time" (e.g. disregarding future wage increases and future discretionary decisions to provide increases to the benefits of current or former participants).
2. Recognition of an overfunded position during the average remaining working lifetime of the participants to the plan (or less).
3. Recognition of a defined benefit obligation (DBO) in excess of "CBO" (or assets, if higher) during the average remaining working lifetime of the active participants (or less).

If the board wishes immediate disclosure of an underfunded position in the balance sheet of the entity, we suggest that the board considers allowing an intangible asset in order to offset the increase in the liability, with amortisation as proposed.

Yours faithfully

**D A Eteen FIA**  
**Principal & Actuary**  
**Chair of the Retirement Benefits Global Practice Council, Aon Consulting Worldwide**

*Aon Limited*

Registered Office: 8 Devonshire Square, London EC2M 4PL  
Registered in London No. 210725 • VAT Registration No. 480 8401 48



### Consequences to the entity:

1. We are concerned that immediate recognition of a transition liability in the balance sheet of an entity could result in a severe deterioration of the balance sheet of the entity.
2. Stock prices have dropped significantly during the past two years. As a result the value of plan assets, separated for the purpose of pension benefits, is also very likely to have dropped significantly.
3. Interest rates are currently low. In some countries the decrease in interest rate did not result in a comparable decrease of wage increases and/or inflation related adjustments of benefits. As a result the defined benefit obligations (DBO) of the plan increased very significantly.
4. We are concerned that the current low market values of plan assets, combined with a high DBO, results in an unusually high transition liability, even to such an extent that solvency requirements of banks and listing requirements of security exchanges may no longer be met. In such circumstances the introduction of IAS19 may put the entity in a very onerous position.
5. Some users of the financial accounts will not immediately be familiar with IAS19-accounting. Especially the concept of the DBO can easily be misunderstood and be confused with a vested benefit obligation (VBO: obligation, assuming end of service on the valuation date), a current benefit obligation (CBO: obligation, disregarding any future events, other than the "passage of time" (e.g. disregarding future wage increases or future discretionary decisions to provide increases to the benefits of former participants), or an accumulated benefit obligation (ABO: obligation, disregarding future wage increase). These users (e.g. financial markets, banks) may be insufficiently aware that a significant part of the DBO relates to the effect of **future** wage increases and **future** decisions to adjust benefits to former participants and does not reflect the **current** benefit obligation. The difference between the CBO and the DBO (that is: the effect of future wage increases and future discretionary decisions to inflate benefits to former participants) could result in a very low (or even negative) net equity position. This could trigger users to take unnecessary measures (e.g. make banks adjust credit line conditions or make stock exchanges ask for a removal of the listing). This could unnecessarily cause severe problems to the entity.
6. We are aware that many entities will be able to introduce IFRS, using a "fresh start" approach. We would certainly encourage those entities to do so. However, in order to also enable the introduction of IFRS to those entities that would be faced with a (severe) deterioration of their net equity position or that would have other serious objections to immediate recognition, we would encourage the board to allow delayed recognition.
7. In this respect we understand that an underfunded position in terms of assets versus CBO needs fast recognition (we suggest to maintain the period of 5 years, but would otherwise encourage the board to allow full disclosure of the underfunded position in terms of assets versus CBO in combination with an intangible asset for the transition amount).
8. We do not agree however, that the board should require immediate recognition of the difference between the CBO (or market value of assets, if higher) and the DBO. We fear that such immediate recognition could unnecessarily bring the entity into severe problems. Since the difference between CBO and DBO relates to a liability that, among others, results from wage and price increases during the average remaining working lifetime we would encourage the board to consider delayed recognition over that period.

9. With respect to a situation of overfunding we note that the consequence of immediate recognition could be that parent entities want to move away assets from a subsidiary, while these assets are not readily available to the subsidiary (e.g. if overfunding can only provide value to the entity through future reductions of the contributions). For that reason we would encourage the board to consider delayed recognition of an overfunded position.

#### **Consequences to financial markets**

10. Users of the accounts may not immediately be familiar with IAS19-accounting. An overreaction may result from sudden large underfunded positions. This could unnecessarily strongly affect the value of the entity at a stock exchange. We encourage the board to allow delayed recognition in order to allow markets to get used to the new accounting methods.
11. Entities may wish to restructure the asset mix in order to avoid “surprises” due to sudden changes in the value of the separated assets. Awaiting the first application of IFRS, such entities may start replacing equity type investments for fixed interest type investments, putting unnecessary downward pressure on stock prices.

#### **IASB-principles**

##### Matching

12. From the principles we understand that matching should be interpreted as administering the consequences of transactions and other events as they occur and attributing them to the period to which they relate. This includes providing for values relating to events in the past, but payable in the future (which could be interpreted as: payable solely due to the “passage of time”).
13. We understand that matching would require full disclosure of an underfunded position in terms of assets versus CBO. We note that the difference between DBO and CBO (or assets, if higher), relates to new future events (e.g.. future wage increases, future decisions to inflate benefits to current or former participants). We also note that the board apparently wishes to disregard the instruments that the entity has to create a better fit between the existing plan and the new accounting methods. These instruments may shift part of the future burden to other parties (to current participants [e.g. through a plan change from final pay to future career average pay], to former participants [e.g. restricting inflationary adjustment of their benefits] or to governments [e.g. spreading alarming rumours and asking for support]).
14. Based on both the character of the difference as well as on the adjusting instruments that the entity may use, we think the principle of matching is better reflected by allowing deferral. Given the character of this difference (it relates to the value of future events during the expected remaining service), we think amortisation should take place over the expected remaining service.

##### Continuity

15. From the continuity principle we understand that the accounts are made up under the assumption that the continuity of the entity is sufficiently guaranteed.

16. We fear that requiring an initial pension liability that is equal to the funded status in terms of assets versus DBO, could result in actions taken by e.g. banks and stock exchanges (see par. 5 en 10), that could unnecessarily severely harm the entity. We note, that such circumstances may push the entity towards a situation of discontinuity. We also note that the actual discontinuity of the entity will release the difference in value between the CBO (or even VBO) and the DBO. The availability of that value may, however, imply that actual discontinuity was unnecessary. We think this is an undesired **paradox**. We are also surprised that the board is willing to accept the risk that its decision, not to allow deferred recognition of the difference between the CBO (or assets, if higher) and the DBO, could result in unnecessary discontinuity.
17. We feel that the board should avoid **paradoxes**. For that reason we encourage the board to allow deferred recognition of the difference between CBO (or asset, if higher) and DBO with amortisation over the expected remaining service.

### **Qualitative Characteristics**

#### Readily understandable

18. In many countries first-time application of IFRS will imply a major change compared to existing standards (changes in all aspects of the plan: valuation of pension assets, pension liabilities as well as pension cost). This is likely to be confusing). Allowing users in the other countries time to get used to the new methods could avoid overreaction due to misunderstanding of the new methods.
19. In our view immediate recognition does not serve this characteristic.

#### Relevancy

20. We do not see why the immediate recognition of the transition amount on first application of the IFRS would be more relevant than the immediate recognition of future actuarial gains and losses.
21. For that reason we see no grounds, based on relevancy, for not allowing deferred recognition for the transition amount, while maintaining the possibility for deferred recognition for future actuarial gains and losses.

#### Reliability

22. We expect that entities will try to manage the transition to IFRS as much as possible. We also expect that the measurement of the DBO is based on numerous assumptions and on data provided by the entity. Especially in circumstances where the net equity position of an entity is poor, immediate recognition could make management more inclined to provide biased information. To the extent that deferred recognition is allowed, this would reduce the immediate pressure on management and therefore contribute to higher quality information to the user of the accounts.
23. In our view reliability is significantly served by allowing deferred recognition.

#### Comparability

24. We understand that requiring a “fresh start” for all entities, including those already using IAS19, would significantly contribute to a better comparability at the date of first application.

25. We wonder, however, whether entities that are already using IAS19, would see restatement as being justified given that, after the first year, the entities will all go their own way, with different actuarial gains and losses, possibly different widths of the corridor and different periods of amortisation. As a consequence, the comparability that existed on first application of IFRS, no longer exists after a few years. In order to compare entities, the users of the accounts will need to consult the notes to the accounts, with the additional information about the unrecognised amounts. We do not see why the "fresh start" comparability would be required on first application of IFRS, and would no longer be required in consecutive years.
26. We therefore think that comparability provides insufficient basis for immediate recognition.