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Dear Sirs

PAAinE Discussion Paper *The Financial Reporting of Pensions*

We appreciate the opportunity to comment on the PAAinE Discussion Paper, *The Financial Reporting of Pensions*. The views expressed in this letter are those of KPMG Europe LLP, which comprises the KPMG member firms of Germany and the United Kingdom.

As an international network, KPMG has a global process in place to respond to international standard setters on behalf of its member firms worldwide. The KPMG International Financial Reporting Group will respond separately to the IASB's Discussion Paper *Preliminary Views on Amendments to IAS 19 Employee Benefits*, for which comments are due by 26 September 2008.

In summary we are supportive of the underlying principle expressed in the PAAinE Discussion Paper. We believe that a consistent approach should be taken to accounting for pension plans as to other assets and liabilities and that conceptually there is no clear reason for maintaining separate recognition and measurement requirements for pension assets and liabilities.

Our response to the specific questions raised in the Discussion Paper is included as an appendix.

We hope that our comments will be useful. Should you have any questions please contact Mark Vaessen on 020 7694 8589.

Yours faithfully

KPMG LLP

KPMG LLP

Q1 Should a liability to pay benefits that is recognised be based on expectations of employees' pensionable salaries when they leave service, or on current salaries (including non-discretionary increases)?

We can see merit in both arguments; for example, in support of using future salaries, that a final salary promise differs from a current salary promise, such that the more relevant measure is the future salary. However, on balance we do not believe that discretionary increases in pensionable salary should be included in the determination of the present obligation at the reporting date and believe that such increases generally *do* remain discretionary. We believe the lack of any commitment at the balance sheet date to provide future increases in salary, particularly in *pensionable* salary, means such increases are not generally current obligations as defined within existing IFRS (such as IAS 37 *Provisions, Contingent Liabilities and Assets*). Since no present obligation exists it would be inappropriate to recognise a liability. In certain specific situations a present obligation to increase future pensionable salaries *might* exist, such as where a constructive or legal obligation arises from union agreed collective bargaining arrangements, in which case it should be reflected in the measurement of the liability.

Whilst historically evidence may exist that future increases in pensionable salary will always be given on the grounds that it may otherwise damage employer/employee relations, in our experience employers in practice are currently making changes to pension schemes (such as closing schemes to future accrual or the award of *non*-pensionable salary increases). These changes suggest that it is not reasonable to assume that the existence of past discretionary increases in pensionable salaries indicates a commitment to award future discretionary increases in pensionable salaries.

We acknowledge that it may be difficult, in some cases, to differentiate between discretionary increases and a constructive obligation. A past history of union agreed collective bargaining arrangements may, for example, indicate the existence of a constructive obligation to increase future salaries beyond the period covered by the current agreement.

The Discussion Paper notes that, were current salaries to be used as the basis for measuring the pension liability, the principles advocated in Chapter 2 would mean that their measurement should reflect any guaranteed minimum increase to which *deferred* pensioners are entitled. This is on the basis that the active members effectively hold an option to require a similar increase from the entity, by leaving. We support this analysis.

Q2 Should financial reporting be based on the premise that a liability is owed to an individual employee or to the workforce as a whole? What consequences do you consider your view has for the recognition and measurement of pension obligations?

Conceptually we believe that liabilities should be recognised based on individual members of the workforce as we believe this better follows the general principles of IFRS (in that a liability arises from services received, and those services are received from individuals based on their individual actions and not from the workforce as a portfolio). Since the workforce is not an asset capable of separate recognition within a business combination under IFRS 3 *Business Combinations* we believe it would be inconsistent to recognise a liability due to the workforce as a unit in relation to a pension promise.

However we agree that in measuring those liabilities a portfolio approach is reasonable, provided the portfolio of employees have similar characteristics and so can be collected together into portfolios with similar risk profiles (if necessary into sub-portfolios). We believe that measurement of the liability at this sub-portfolio level is an appropriate approximation of the liability owed to individual employees.

Q3 Do you agree that recognition should be based on the principle of reflecting only present obligations as liabilities?

We agree that only present obligations should be reported as liabilities. We believe that it would be inconsistent with our response to Question 1 (that recognised liabilities should not include discretionary salary increases) to recognise liabilities for other obligations.

Q4 Do you agree that the consolidation of pension plans should be subject to the same principles as are usually applied in determining whether consolidation is appropriate?

We agree that pension plans should be subject to the same principles as other arrangements when determining whether consolidation is appropriate. However, we believe that a more detailed explanation will be required as to how EFRAG believes that 'benefit' should be assessed – in the context of determining control – in relation to pension plans.

Q5 Do you agree that changes in assets and liabilities relating to pension plans should be recognised immediately, rather than deferred and recognised over a number of accounting periods or left unrecognised provided they are within certain limits (a 'corridor') approach?

We agree that the option to apply the corridor approach should be removed as there is no conceptual basis within IFRS to justify the deferral of recognition of changes in assets and liabilities relating to pension plans or the subsequent recognition of 'excess' changes over a number of accounting periods.

We agree that immediate recognition of these changes provides more transparent information on the financial position of the reporting entity and better compliance with the IFRS Framework. We acknowledge that the removal of the corridor approach will increase volatility reported within the financial statements but do not believe that this approach, which is required by FRS 17 *Retirement Benefits,* has caused widespread misunderstanding in the UK.

We note that the IASB have put forward a similar proposal in its Discussion Paper *Preliminary Views on Amendments to IAS 19 Employee Benefits*.

Q6 Do you agree with the paper's views in the measurement of liabilities to pay benefits? In particular, do you agree that:

- **Regulatory measures should not replace measures derived from general accounting principles?**

We agree that regulatory measures should not replace measures derived from general accounting principles for the normal measurement of liabilities to pay benefits; regulatory requirements of different countries may differ and consequently different measurement principles would be applied to similar benefit obligations.

The general objective of regulatory measures is to preserve the funding status of the pension plan (for example by specifying the level of assets to be set aside to meet plan obligations or pay benefits). Whilst they are therefore the most relevant measure to use in determining the contribution rates of the employer – and therefore its cash flows in the shorter term – it is difficult to see how they can provide the most relevant information on the underlying obligation to pay benefits, the ultimate settlement of which may result in recovery by the entity of some part of cash flows previously injected into the plan to provide a prudent cushion.

However we accept that in some cases regulatory measures will also *be* the required accounting measure – for example if the employer triggers an event (such as the closure of the plan and buyout of the pension obligation) that will require the liability to be settled at an amount required by law (the buyout amount), or a binding commitment to provide funding that will be irrecoverable, giving rise to an onerous contract. In our view this is then the amount that should be recognised under general accounting principles.

- **The discount rate should reflect the time value of money only, and therefore should be a risk-free rate?**

We tend to see pension liabilities as a form of insurance contract and therefore agree with the approach taken by the Discussion Paper of looking at the proposals set out in the IASB's Discussion Paper *Preliminary Views on Insurance Contracts*. We agree that the discount rate used in pension accounting should be a risk free rate *provided that* the cash flows used to compile the liability are appropriately risk weighted: risk must be reflected in the measurement of the liability in one way or another. We find the Discussion Paper unclear as to whether it believes that the gross cash flows for pension accounting should be risk weighted, as the IASB proposes for insurance contracts. The discussion generally seems to suggest that the approach proposed for pensions is the same as that for insurance, and the term 'expected value' is used in 5.6.27, for example, yet the more detailed proposal seems to be that the pension cash flows used would be the entity's best estimates, as they are at present under IAS 19 *Employee Benefits*. Best estimates would not, in our view, be risk-adjusted cash flows; we believe that reflecting risk at this gross cash flow level would mean using probability-weighted estimates of a range of outcomes. (We agree that these should be entity-specific estimates, both of the potential outcome and of its probability.)

We note that we do have some concerns about the practical application of this point, as we believe it may be difficult for an employer to derive these probability estimates, although we note also that this might be viewed as simply another – extreme – type of estimate to be made in drawing up financial statements.

Despite our general support for the Discussion Paper having regard to the principles of the IASB's Discussion Paper on insurance accounting (primarily that an exit value measure (discounted using a risk free rate) of fair value should be used), we acknowledge that insurance accounting under IFRS is not yet well-developed. This makes it difficult to conclude definitively that the eventual principles for insurance accounting will be appropriate for pension accounting but we believe that future work on pensions should continue to monitor the insurance project.

- **Information about the riskiness of a liability (i.e. the risk that the amount of pension benefits will differ from today's expectations) is best conveyed by disclosure rather than by adjusting the amount of the reported liability?**

The IASB's Discussion Paper on insurance contracts proposes that a risk margin should be added to the net present value calculated by applying a risk-free discount rate to risk-adjusted cash flows. We believe that the 'certainty equivalent' element of this should *in principle* be added also in measuring a pension liability. However, we note the discussion in PAAinE's paper about the difficulty of establishing the amount the margin for pension liabilities, given for example the absence of an observable transaction price.

When responding to the IASB's Discussion Paper on insurance contracts, KPMG's International Financial Reporting Group commented that: "We believe ... that a margin that compensates the insurer for risk should be identified within any measurement model for insurance contracts. In order to meet the Board's objective, in our view, the risk margin should be capable of being measured reliably and consistently at each reporting date, separately from the remeasurement of expected future cash flows." The response commented further that "the measurement of the risk margin should be based on the information and techniques that the reporting entity would use to measure the margin that it applies internally for pricing, for regulatory purposes or for reporting to management", tested against any available external information.

Since, as noted elsewhere, we tend to see pension liabilities as a form of insurance contract, in principle we believe that this same approach should be applied in measuring pension liabilities. However, we note that we would not expect that employers will generally be measuring a risk margin relevant to pension liabilities for any of the reasons set out above, such that it could be measured reliably and consistently at each reporting date.

Therefore, we believe that developments in the insurance accounting project, and by the IASB more widely should be monitored in case in due course they provide a solution for pension accounting, as should developments in the market for pension liabilities. At present we have not identified an appropriate basis for deriving a 'certainty equivalent' margin to apply to the discounted cash flows, leaving information on the riskiness of the liability to be explained through narrative and numerical disclosure.

- **The liability should not be reduced to reflect its credit risk?**

We note the arguments set out in section 7 of Chapter 5 for and against the employer's own credit risk being reflected in the measurement of its pension liabilities. In the 'against' list, we note in particular the view it would be inappropriate for entities with reduced creditworthiness to recognise a reduced liability for pensions when, on a going concern basis, their liability to pay benefits in the future is unchanged; and that an employer could not crystallise this apparent gain by transferring the liability at this (lower) value to a third party, since that third party would be accepting the unreduced obligation and so would require full payment at the unreduced amount.

This point was noted also in the response of KPMG's International Financial Reporting Group to the IASB's Discussion Paper on insurance contracts: "... we believe that remeasuring insurance liabilities for changes in an entity's own credit risk would not meet the objective of providing users with information about the amounts, timing and uncertainty of future cash flows from the entity ... because it is unlikely, in most cases, that insurance liabilities will be settled through transfer, and perhaps even less likely that such a transfer would be priced taking into consideration the credit rating of the transferor."

However, we see the inclusion or not of the entity's own credit risk in measuring liabilities very much as a cross-cutting issue, to be considered on a more general basis as well as in the particular circumstances of measuring pension liabilities (and insurance contracts). Developments in thinking may determine whether a single solution should be applied to all liabilities, or whether there should be different solutions for different types of liability, as currently. We believe that PAAinE should monitor the IASB's work in this area.

- **Expenses of administering the plan's accrued benefits should be reflected in the liability?**

We agree that future expenses of administering the plan's accrued benefits should be recognised as part of plan liabilities – they represent a present obligation.

However we believe it is likely to be difficult in practice for a plan to identify the change in this liability in subsequent periods (representing the release of the liability relating to the current period and the addition to the liability representing the current best estimate of the future costs of administering accrued benefits) and to separate the expense of administering accrued benefits from the ongoing expense of administering the overall plan.

We do not believe that levies based in part on the solvency of the plan should be included within plan liabilities, since we believe that they are analysed more appropriately as quasi insurance premia payable in respect of each plan year.

Q7 Where employees have options to receive benefits in different ways, should the liability be reported at the highest amount or at an amount that reflects the probability of different outcomes?

We note that the Discussion Paper expresses no preference between these views. Whilst the employer does not have an unconditional right to refuse to pay benefits in the manner specified by the employee, we do not believe that the liability should be reported at the highest amount.

We believe that the liability should be based on actuarial assumptions relating to the expected range of possible outcomes. This is consistent with our position expressed above that it is the cash flows relating to the payment of the liability itself that are risk adjusted. In our view, reporting the liability at the highest amount would not be consistent with this approach. It would also be treating the liability in the same way as if it were a financial instrument: we view the net obligation of the employer as a type of insurance contract, rather than a financial instrument, and so do not attempt to apply the requirements of IAS 32 *Financial Instruments: Presentation*.

Q8 Do you agree that assets held to pay benefits should be reported at current values?

We agree that assets held to pay benefits should be reported at current values, since we believe that this provides the most useful information about the extent to which the committed pension payments – measured at a current value – are currently funded.

This approach means both assets and liabilities are recognised at a balance sheet date value.

Q9 Do you agree that a 'net' asset or liability should be based on the difference between the amounts at which the assets and liabilities would be measured if they were measured directly?

We agree that the net asset or liability recognised by an employer should be measured using the same principles as are relevant for the underlying assets and liabilities. We believe it would be inconsistent with our views in Question 6, in respect of regulatory measures, to look to an alternative measure of the employer's net asset or liability that reflected its expected funding cash flows.

Q10 Do you agree that different components of changes in liabilities and/or assets should be presented separately?

We agree that different components of changes in liabilities and/or assets should be presented separately. However, we do not agree entirely with the classification proposed within the Discussion Paper. We suggest that the classification of changes in assets and liabilities should follow the basic principles of IFRS, in line with the underlying concept that pension related items are no different from other items of income and expense.

Where we differ from the Discussion Paper's proposals is that we believe that non-discount-rate-related actuarial gains and losses (experience adjustments and changes in assumptions) should be recognised within operating, rather than within other financial performance.

We believe that this classification is more consistent with the treatment of changes in the estimated amount of other provisions under IAS 37 where revisions to estimates follow the classification of the original charge.

Q11 Do you agree that the financial performance of an entity should reflect the actual return on assets, rather than the expected return, and that the expected return should be required to be disclosed?

As noted in our response to Question 10, where we agree with the Discussion Paper's proposal in this respect, we believe that the actual return on assets should be recognised in the income statement, as a financing item.

In our view, the expected return on assets does not result from an actual transaction for the period and so should not be recognised separately from the actual return on assets.

We believe that disclosure of the expected return on assets might be of value to the reader of the financial statements as it enables them to understand the employer's expectation of future investment returns, but wonder about the priority this should have compared with other possible disclosures. Our views on disclosure requirements are discussed further below.

Q12 Do you agree with the objectives of disclosure that are identified in this Chapter? Are there specific disclosure requirements that should be added to or deleted from those proposed?

We agree with the basic principles of the Discussion Paper and the objectives of disclosure that it develops. We are concerned that the disclosures given should be proportionate and therefore welcome the focus on the materiality of the plan to the reporting entity in determining the disclosures to be made. We believe that these disclosures should not constitute a 'checklist' but should be directed clearly towards satisfying the objectives, without providing an overwhelming amount of detail. The need for the key disclosures to be prioritised, and lesser ones omitted, should be borne in mind when a revised IAS 19 is developed.

In our view some of the more important disclosure is in the following areas:

- Sensitivity analysis – since there are many uncertainties within the pension calculation, both in terms of the different possible measurement bases and uncertainty around a number of different inputs, we believe it is not possible for a single number to encapsulate all of the required information about the plan.

- Alternative measures, such as the increase in plan liabilities if it were based on expected future salaries (assuming the balance sheet liability includes current salaries and increases relating to constructive obligations only), since these give additional information on the range of possible outcomes, albeit by changing measurement approach, rather than by flexing the estimated outturn under the core approach.

- Information on regulatory measures – since these indicate the cash flows the employer is required to make, based on local regulatory requirements.

- The timing of cash flows from plan to member and any related guarantees – since these indicate the timing and amount of possible additional funding calls on the employer.

Q13 Do you agree that multi-employer plans should be reflected in an employer's financial statements using the same principles as those that apply to a single employer plan? How, in your view, should an accounting standard require that this be implemented in practice?

We agree that, conceptually, multi-employer plans should be reflected within the employer's financial statements using the same principles as apply to a single employer plan. We agree that the use of an allocation key is an appropriate method of allocating the net surplus or deficit within the multi-employer plan to the individual member employers and that this allocation should be made, and generally should reflect whatever basis is used to allocate contributions between the various employers, as being the best indicator of future cash flows re past service. (However, we note that recognition of an asset is likely to be rare, since the employer is unlikely to control access to that potential benefit.)

In our view, the use of a consistent allocation method to derive a liability to be recognised, whilst it may result in the recognition of amounts different to the individual employer's specific accumulated pension obligations, had it been possible to calculate these, is preferable to defined contribution accounting in the individual employer's financial statements. Even though 'defined contribution' accounting would be accompanied by enhanced disclosures, we believe that the entity's obligation to contribute towards any deficit as a result of its participation in the plan is given greater prominence and reported more appropriately with the allocation key approach.

We further believe that the above principles should apply also when no IFRS-compliant valuation of the multi-employer plan exists; again, an estimate of the liability made on a consistent basis year by year is preferable to none. We believe that additional disclosure should be given, such as the basis and significant assumptions used, for any non IFRS-compliant valuation.

Should the employer be unable, despite its best efforts, to obtain the information necessary to take the above approach, we agree that the 'third alternative' set out in Chapter 10 should be taken.

The comments above do not apply when an employer could 'walk away', in which case we agree that the employer's obligation should be limited to the contributions currently payable.

See our response to Question 16 below for a discussion of common control plans.

Q14 Do you agree that a pension plan's general purpose financial report should include its liabilities to pay benefits in the future? Do you agree that the plan's liabilities for future benefits should be quantified using the same principles as an employer's liability?

We agree with the general concept put forward by the Discussion Paper that the general purpose financial reports of pension plans should follow the same underlying IFRS principles as those of other entities. However, we note that plans may not be required, and may not elect, to prepare such general purpose financial statements and may instead prepare financial statements only for regulatory purposes.

Based on this general principle we see no conceptual reason why the general purpose financial statements of pension plans should not include liabilities to pay benefits in the future; the obligation to pay benefits meets the definition of a liability within the IASB *Framework for the Preparation and Presentation of Financial Statements* (paragraph 64 states that examples of liabilities arising through the existence of a present obligation but measured through a substantial degree of estimation include pension obligations) and we believe that the plan itself has an obligation to pay those benefits.

Since we believe that the liability of the pension plan to pay benefits is a liability within the 'normal' Framework (as would be applied in the general purpose financial report of the employer) we believe the liability recognised within the general purpose financial report of the plan and the employer should be measured on the same basis, although we note that the trustees may use estimates that differ from those of the employer.

Q15 Do you agree that a pension plan's statement of financial position should reflect an asset in respect of amounts potentially receivable under an employer's covenant, and that this should reflect the employer's credit risk?

We agree that any legally agreed specific funding (for example, a schedule of contributions in the UK) over and above future service contributions represents an asset of the plan, to be dealt with as set out in the first sentence of section 11.7.2.

In particular, we agree that such a financial asset should be measured under IAS 39 *Financial Instruments: Recognition and Measurement* and should therefore include adjustment for the credit risk of the employer. We note that this produces an apparent measurement mismatch if the employer's liabilities are measured at an amount that does *not* reflect its credit risk, but note that so far as the plan is concerned the asset measurement would be reflecting the credit risk of a third party.

Whilst we accept that the employer has made a promise to 'stand behind' the obligation of the plan, and in some jurisdictions may be required to do so, we are not convinced that amounts beyond legally agreed specific funding amounts (the "employer's covenant", as defined in 11.7.2) represent an asset of the plan. In the absence of specific IFRS guidance on this form of asset, we believe that this promise/requirement represents a contingent asset of the plan and so should not be recognised.

In any case, we do not believe that inclusion of an asset for the employer's covenant is of greater value to the reader than disclosure of the shortfall of assets against liabilities and a detailed discussion of – for example – the extent to which the employer is required by the legal framework within which it operates to stand behind the plan, the assessment by external credit rating agencies of the credit risk of the employer and other relevant information.

We believe that reporting a deficit (if relevant) is of value to the reader of the general purpose financial statements, showing:

- The amount to be covered by future contributions or investment returns, but where the precise source is not yet known.

- A deficit that does currently exist (but that in time the employer is required to make good in terms of future contributions if required), meaning that there is a risk to the plan that the employer may not be able to make any required payments at the time they might be called for.

The Discussion Paper looks to the symmetry of accounting between employer and plan for support of the recognition of the asset outlined above; we do not believe that symmetrical accounting is always desirable or possible under the general IFRS principles.

With respect to any asset that might be recognised for the employer's covenant, we note that we are uncomfortable with the concept of trustees being required to apply their estimate of the employer's credit risk is assessing the amount to be recognised; the information required to determine employer credit risk may not be publicly available.

Q16 Are there types of pension arrangements that require further consideration? Please identify the specific features of these arrangements and suggest how the principles of this paper would require development to secure appropriate financial reporting for them.

Common control plans

We note that Chapter 10 of the Discussion Paper does not deal with plans sharing risks between entities under common control (as defined in IAS 19 paragraphs 34-34B); we suggest that this is a significant area requiring further work. As there is no consistent concept in IFRS for separate financial statements of companies under common control and a mixed approach to these separate financial statements is evident from IFRS themselves, we believe that this is an area where developments in accounting for pensions should track the developments of the concepts more generally in IFRS.

- If the future concept in IFRS is that separate financial statements are prepared as if the entity is not under common control, we believe that the above principles for multi-employer accounting should apply. (We note, however, that if an exemption from making and accounting for an allocation is granted to multi-employer plans where an IFRS-compliant valuation of the plan is not available, that we believe this exemption should not be available to common control schemes. Further, we believe a rebuttable presumption should exist that the allocation key for common control plans should be the basis used to allocate contributions.)

- If IFRS continues to incorporate a mixed model of allowing separate financial statements to reflect the amounts paid or book values, we believe that the requirements for common control schemes should be similarly permissive as in the current IAS 19.

Separate vs. consolidated financial statements of employers

Whilst we agree with the underlying principles expressed in Question 4 that the consolidation of pension plans should be subject to 'normal' IFRS principles and of Question 8 that a single net asset or liability should be reported when the employer does not consolidate the plan, we are concerned that no consideration has been given to the accounting in separate financial statements where the plan is consolidated into the group financial statements.

We believe that in such cases the employer should recognise a single net asset or liability, as if at consolidated level the plan were not controlled, if this is the most appropriate reflection of its exposure to risk and access to benefit from the plan at the individual entity level. Chapters 3 and 7 should make clear its application to both the individual/separate and consolidated financial statements of the employer. We note that it would appear that the Question of consolidation is irrelevant in cases where the consideration of sections 3.2.41 and 3.2.46 leads to the gross presentation of 3.2.46 within the individual financial statements.

Q17 Are there further specific issues relating to the cost and benefit of the proposals that should be taken account of in their further development?

We have no further comments to add.