Response No.98

DUTCH ACCOUNTING STANDARDS BOARD (DASB)

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EFRAG
Attn. EFRAG Technical Expert Group
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Our ref : CvC
Date : Amsterdam, 16 July 2008
Re : Comment on PAAinE Discussion Paper Financial Reporting of Pensions

Dear members of the EFRAG Technical Expert Group,

The Dutch Accounting Standards Board (DASB) appreciates the opportunity to respond to the PAAinE discussion paper on the Financial Reporting of Pensions.

We have recently held a public meeting on the reporting of pensions. Over 100 participants attended, representing a cross section of those with an interest or an involvement in the subject. Our responses and comments reflect the outcome of that public meeting as well.

The changes in labour relationships (for example flexible contracts), labour mobility (life time employment with only one employer is rare these days) and terms of employment (for pensions average salary pay plans are common, final pay plans are an exception) require a fundamental review of the current accounting of post-employee benefits. The discussion paper 'The Financial Reporting of Pensions' of EFRAG/ASB summarizes the critical conceptual arguments for various approaches and therefore is in our view a very good starting point for this fundamental review and a basis for future changes of the current accounting method for post-employee benefits.

In our responses to the various questions we have given our views on the issues raised. This is included in appendix A to this letter. However, we believe that there is one issue somewhat underexposed in the discussion paper. This is the situation where the risks inherent in a pension plan are shared between the parties involved, i.e. employer, employees, former employees and retirees, a situation that is quite common in The Netherlands. Effectively, such a plan will, depending on the performance, result in variable benefits for the plan participants. We did not find that the discussion paper covers a situation comparable to a variable benefit plan. In appendix B to our response letter we have provided a summary of the main features of such a plan and our views on the way it should be accounted for.

In addition, we would like to express certain views on mandatory multi-employer plans, which are common in the Netherlands and generally mandatory on an industry-wide basis. Mandatory multi-employer plans often have the same characteristics as state plans. In line with paragraphs 4.3 and 4.4 in chapter 10 we think that the employer's obligation in these plans at any point in time is limited to the current contributions payable. For these mandatory industry-wide pension plans we would expect the same treatment as for state plans. Additional information regarding these plans should be disclosed rather than reflected in the balance sheet or on the face of the income statement. Please refer to appendix C for more details on the mandatory multi-employer plans, or mandatory collective employee benefit plans.

Of course we would be happy to discuss our reaction with you.

Yours sincerely,

Hans de Munnik
Chairman Dutch Accounting Standards Board

Appendix A Answers to the questions and other comments

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 believe that the basis of recognition of the liability depends on the kind of obligations as included the plan. A distinction should be made between pension plans that are based on average pay and final pay.

For average pay plans, we believe that the present obligation should be based on the current salary, including non-discretionary increases. This includes only benefits that the entity is presently committed (by legal or constructive obligation) to pay. A liability (and expense) does not arise in respect of future increases in benefits until the entity is committed (by legal or constructive obligation) to pay them. The liability should be based on the current salary, but should also include the increases in salary that the company is committed to by individual contract or by a current collective labour agreement, therefore including non-discretionary increases.

For final salary plans, our board is split along two different views. Some believe that the present obligation should be based on the current salary including the increases in salary that the company is committed to by individual contract or by the current collective labour agreement, therefore including non-discretionary increases. Others believe over and above that the present obligation should be based on expectations of employees' pensionable salaries when they leave service. This would include the expected future salary increases as the entity is committed to a pension based on expected salary at pension date.

In general, it is believed that the liability should also include increases in the pension obligation due to indexation of the pension payments (with e.g. inflation) if the company is committed to these increases by agreement.

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?

We believe that using the whole workforce rather than an individual should not give rise to a different view on the recognition of a liability, because the obligation to the whole workforce should be the sum of the obligations to individuals.

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

Yes, see also the response to question 1.

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?

Yes, we agree that the same principles should be applied in the consolidation of pension plans. However, given the legal requirements for pension funds in The Netherlands, we very much doubt whether a consolidation issue should arise in The Netherlands for pension plans. Nevertheless, we would recommend further guidance on when control exists over a pension fund, as the relationship between the entity and the pension fund could include some specific aspects (e.g. shared control by employer and employees), that could be difficult in the evaluation of the control aspect.

Q5 Do you agree that changes in assets and liabilities relating to pension plans should be recognized 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 in principle with the approach that changes in assets and liabilities relating to pension plans should be recognized immediately, as the delayed recognition is not in compliance with the framework. However, we believe that direct recognition should only be applied under the following conditions:

- Measurement of the pension obligation based on the commitment (by legal or constructive obligation) to pay, which is not equal to the PUC method, which also includes future non-discretionary salary increases.
- Presentation of the different components in separate categories in the profit-and-loss statement, in which actuarial results are not part of operating income.

Should the determination of the pension liability be based on future salaries and include many assumptions, we believe that the following comments (based on the opinion of the IASC when IAS 19 was issued), are still applicable.

- Immediate recognition can cause volatile fluctuations in liability and expense and suggests an unrealistic degree of accuracy. This volatility may not be a faithful representation of changes in the obligation but may simply reflect an unavoidable inability to predict accurately the future events that are anticipated in making period-to-period measures; and
- In the long term, actuarial gains and losses may offset one another. Actuarial assumptions are projected over many years, for example, until the expected date of death of the last pensioner, and are, accordingly, long-term in nature. Departures from the assumptions do not normally denote definite changes in the underlying assets or liability, but are indicators which, if not reversed, may accumulate to denote such changes in the future.

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 would not exclude regulatory measures as an acceptable measurement of liabilities. We believe that, from a pragmatic viewpoint, it would be more appropriate, for example, for the standard to lay down certain key recognition and measurement principles and permit entities to use local regulatory measures where these are shown to be materially in line with those key principles.

- The discount rate should reflect the time value of money only, and therefore should be a Risk-free rate?
Yes, risks and uncertainties in the pension plan cash flows should be taken into account in measurement of the liabilities by risk-adjusting the underlying expected cash flows and applying a discount rate which excludes these risks.

- 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?
Companies should take into account their best estimate of the risks and uncertainties in the pension plan cash flows in measurement of the liabilities as at reporting date. We believe that the estimates and risks should be disclosed.

- ***The liability should not be reduced to reflect its credit risk?***
Yes, risk free interest rate should be applied to measure the liability.

- Expenses of administering the plan's accrued benefits should be reflected in the liability?
We believe that expenses should be accounted for in accordance with their substance. Non-investment related expenses that are an integral part of the entity's obligation to administer the pension plan and that are related to accrued benefits should be reflected in the liability (included in the actuarial assumptions used to measure the defined benefit obligation). Expenses related to future accrual of benefits however should be reflected in the cost of future accruals. As the expenses of administering a plan can differ we recommend to include guidance on which expenses should be qualified as directly linked.

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 ?
The liability should be reported based on a best estimate or expected value, which reflects the probability of the different outcomes.

Q8 Do you agree that assets held to pay benefits should be reported at current values?
We believe the valuation of assets held to pay benefits should not be considered on a stand-alone basis, but should be seen in connection with the valuation of the plan liabilities. For the valuation of the plan liabilities reference is made to the answer to question 5. Whilst in principle we believe that the assets held to pay benefits should be reported at current value, in situations where for instance indexation is conditional on investment returns, there may be a need to reconsider the appropriate level of indexation estimates used in the calculation of the pension obligations, if these result in a deficit. .

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?
If the liabilities and assets are determined based on our answers to previous question, we 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 would like to emphasize that employers do not have control over trust/pension funds in the Netherlands. Furthermore we want to refer to appendix B in this letter. In some plans, dc-accounting will lead to more useful accounting results than the net asset or liability approach.

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

In general we think that presentation of pension expenses should be aligned with the nature of the expense components, i.e.

1 Service cost
2 Interest cost (finance cost of pensions as referred to in S32) should be on the same line item as the direct return on assets (being the direct realised return on assets rather than total actual return on assets (including unrealised fair value changes) as referred to in S32 ad S34);
3 Effect of change in financial assumptions (i.e. discount rate) should be on the same line item as unrealised fair value changes (indirect returns) on plan assets;
4 Effect of change in other (non-financial) assumptions

The cost as mentioned under bullet 2 should be reflected on the face of the income statement within financing cost. For the income/cost as mentioned under bullet 3 we believe presentation in 'other comprehensive income' or presentation on the face of the income statement (within finance) would be subject to fundamental (broader) discussion regarding financial statement presentation. The same holds for effects of other changes in assumptions (bullet 4). Furthermore we believe service cost should be presented within operating expenses.

If different components of pension expense are presented differently a summary of total pension expense should be disclosed.

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?

Yes, see our answer to Q10.

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 believe that answering this question is not useful without first having a clearer view of the financial statement presentation (Q10 and Q11). We also think that in the fundamental review of pension accounting the disclosure requirements are a matter of secondary importance.

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?

No, we do not agree. Mandatory multi-employer plans often have the same characteristics as state plans. In line with paragraphs 4.3and 4.4 in chapter 10 we think the employer's obligation in these plans at any point in time is limited to the current contributions payable. For these mandatory industry-wide pension plans we would expect the same treatment as for state plans. Additional information regarding these plans should be disclosed rather than reflected in the balance sheet or on the face of the income statement. Please refer to appendix C for more details on the mandatory multi-employer plans, or mandatory collective employee benefit 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?

First we would like to mention that in our view chapter 11 is only slightly related to chapter 1 to 10 that deal with employer's accounting for post-employment benefits/pensions. Therefore we believe that the discussion regarding financial reporting by pension plans should not be part of this discussion paper. The inclusion of this subject triggers a broader discussion than pension accounting by employers alone and should probably also include accounting for insured pension plans by insurance companies. We do not think that including this subject in the discussion paper would benefit a fundamental review of accounting for pensions by employers.

However, in answer to the question we are convinced that a pension plan's statements of financial position should obviously include its liabilities at the balance sheet date to pay benefits in the future. This liability should reflect the pension fund's liabilities which can differ from the employer's liability and therefore does not have to be equal to the employer's liability.

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 would not agree. We believe any amounts receivable form the employer would normally be unpaid contributions (short term). The receivables should be treated like all other receivables and their recoverability should be assessed through regular impairment testing.

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.

As stated in our covering letter, we believe that there is one issue somewhat underexposed in the discussion paper. This is the situation where the risks inherent in a pension plan are shared between the parties involved, i.e. employer, employees, former employees and retirees, a situation that is quite common in The Netherlands. Effectively, such a plan will, depending on the performance, result in variable benefits for the plan participants. We did not find that the discussion paper covers a situation comparable to a variable benefit plan. In appendix A to our response letter we have provided a summary of the main features of such a plan and our views on the way it should be accounted for.

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?

None.

Appendix B

Variable benefit plan

The features of a variable benefit plan are:

1. Variable benefit plans are pension plans in which the actuarial and investment risk associated with the employee benefit plan are predominantly subscribed by the plan participants (employees, former employees and retirees) and only limitedly by the sponsoring entity. The plan is legally separated from the entity and is administered and governed by an independent body (often a Foundation: from now on described as the pension fund).
2. A variable benefit plan contains a benefit formula that is linked to employees' remuneration and years of service with a benefit formula based on current salaries and conditional indexation rights. Indexation will only be granted if the pension fund holds sufficient resources.
3. A variable benefit plan is funded both by the employer and employee. The employee's component is withheld by the employer from the employee's salary and paid to the fund together with the part the employer is required to pay. The attribution of the employers and employees' part of contribution is subject to periodic labour agreement negotiations.
4. The contribution level payable to the pension fund is part of labour agreement negotiations between employer and employee (the latter represented by unions or work councils) but should *at a minimum* be sufficient to cover the costs of future benefits according to the current terms of the plan and be measured according to an actuarial valuation method. Employer and employees could agree to reduce the level of future benefits in order to avoid an otherwise necessary contribution level increase.
5. The board of the pension fund is composed of an equal number of representatives from both employers and (former) employees. The board of the pension fund is required by law or by articles of association to act in the interest of the fund and of all relevant stakeholders in the scheme, i.e. active employees, inactive employees, retirees, employers.
6. The pension fund centrally administers the plan assets that are generated by the contributions of the sponsoring employer, and uses these assets only to provide benefits to the participants (formerly) employed by the sponsoring employer. The pension fund is by law responsible for the payment of the benefits to the retirees according to the agreed pension terms.
7. The employer(s) are not able to control, currently or potentially, the pension fund assets and activities because of the fact that the board is equally represented by employers and employees and consensus should be reached on each and every board's decision.
8. The board of the pension fund is responsible for the investment policy with regard to the assets of the fund. Generally, this means that they will give instructions to investment funds to invest and administer the plan assets taking into account specific risk management policies, asset mix allocations and administrative procedures. The ultimate responsibility of the asset mix allocation rests with the board of the pension fund and not with the employer or group of employers contributing to the fund.

9. The board of the pension fund is responsible for a proper execution of the pension terms. Pension terms cover at least the following:
    a. Determination of pension benefits (plan benefit formula; indexation measures) and payment thereof;
    b. Conditions and procedures for individual value transfer; and,
    c. Possible measures to be taken in the case of shortfall in the fund's assets.
10. Typically measures that can be taken from year to year (and notably in case of underfunding) by the board of the pension fund are primarily a foregoing of the indexation of accrued pension entitlements (risk borne by active employees, former employees and retirees) because of the contractual arrangement that indexation can only be granted if the fund has sufficient resources. If after the foregoing of indexations, a shortage still exists compared to a minimum funding level, available measures are:
    a. A reduction of pension entitlements that are earned by the active employees in the current service period (risk borne by active employees);
    b. A reduction of accrued pension entitlements (risk borne by active employees, former employees and retirees);
    c. An increase of contribution levels payable to the fund (risk borne by employer and employees as result of the shared funding system).
11. The board of the pension fund is required by law or by the articles of association to act in the interest of the fund and of all relevant stakeholders in the plan and this includes the consequences of taking the aforementioned measures. Therefore, in a variable benefit plan all stakeholders are exposed to actuarial and investment risk but the risks rest predominantly upon the (former) employees and retirees since the benefits are variable in nature. Due to the conditionality of indexation grants the ultimate benefit to be paid to the retirees is subject to a high degree of variability (even with modest inflation forecasts, subsequent indexation might comprise approximately 70% of the ultimate payment to the retiree).
12. In case of a pension surplus the board of the pension fund decides on the allocation of the surplus among the stakeholders. Because of the fact that the indexation entitlements are conditional (depending on a sufficient level of the fund's assets), the surplus is typically used for the indexation of pension entitlements (beneficiaries are the participants, active and former employees and retirees).
13. In case of termination of the plan or the fund itself, the board of the fund decides on the allocation of the surplus or the deficit amongst the stakeholders, taking into account the requirement to act in the interest of all relevant stakeholders in the scheme.

We believe that the risks for the employer out of such a variable benefit plan are not such that it will result in a liability if certain conditions are met. These conditions are:

a. The plan should be administered by an independent entity (pension fund) with a board in which the employer and participants to the plan are at least equally represented and which fully controls the assets and the activities of the plan;

b. The board of the pension fund should be required by law or by the articles of association to act in the interest of the fund and of all relevant stakeholders in the scheme, i.e. active employees, inactive employees, retirees and employers;

c. A curtailment, settlement or amendment of the terms of the employee benefit plan must ultimately be approved by the board of the fund and could not be forced unilaterally by one of the stakeholders in the plan;

d. In case of termination or unwinding of the pension fund the board of the pension fund decides how to allocate the surpluses or deficits among the stakeholders;

e. The plan benefit formula should be based on current or career average salaries; indexation of entitlements will only be granted by the pension plan if the plan holds enough resources (therefore: indexation is conditional on availability of funds);

f. In case of pension plan deficits or surpluses towards a legally or statutory required minimum funding level, the board of the pension fund decides how and to which extent the deficits and surpluses should be divided among the stakeholders;

g. The plan should be mutually funded, both by employers and by employees. The funding level should be agreed by both parties. If the agreed funding level is not enough to cover all pension costs under the plan, the Board has a mandate to take adequate measures in order to align the future pensions costs with the agreed funding levels; and,

h. In any case the funding level should be based on reasonable actuarial assumptions and should in this regard be sufficient to cover all the pension expenses in a determined future period .

The sponsoring employer shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from variable benefit plans. For each separate plan the entity shall disclose:

- the relevant terms of the benefit plan;
- the relevant elements of the funding agreement (if any) with the pension fund, e.g. fixed contribution arrangements, maximum contributions levels, frequency of resetting pension contributions, predetermined relationships between funding level of pension fund and contribution level of the sponsoring entity and the actuarial assumptions that are used in setting the yearly or periodic contribution level;
- to the extent that a surplus or deficit in the plan may affect the amount of future contributions;
    - any available information about that surplus or deficit;
    - the basis used to determine that surplus or deficit;
    - the implications, if any, for the entity;
- The measures that the board of the fund might take in case of eventually arising surpluses and deficits within the plan; and,
- Anything else deemed relevant considering the pension plan or pension fund.

Appendix C

Mandatory collective employee benefit plan

Features of mandatory collective employee benefit plan

1. A mandatory collective employee benefit plan is a specific type of a variable benefit plan. All the features of a variable benefit plan as described above apply as well to mandatory collective employee benefit plans. In addition the following features are inherent in a mandatory collective employee benefit plan.
2. Mandatory collective employee benefit plans are plans in which various entities are involved that are not under common control. The plan pool the assets of the contributing entities and use those to provide benefits to employees and former employees of the entities on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employe(d)s the employees concerned.
3. By law or collective labour agreement employers are obliged to pay contributions to the scheme; sometimes it is possible for a sponsoring employer to opt out of the scheme, but only if there is a company pension fund or insurance scheme that offers terms that are at least equal to those of the compulsory scheme.
4. If the entity ceases to employ members of the collective plan, it will have no obligation to pay the benefits earned by its employees in previous years and the entity has no legal or constructive obligation to pay those benefits in the future.
5. The individual employer does not have significant influence in the design of the employee benefit plan.
6. The board of a pension plan is legally responsible to provide benefits to the participants in the plan. The responsibility of the sponsoring entities is limited to the payment of contributions to the plan as agreed in a collective labour agreement.
7. In a mandatory collective employee benefit plan the individual employer is not able to significantly influence the policies and decisions of the board since the board consists of representatives of employers' associations and employee unions. The representatives of the employers' associations should act in the interest of the all employers involved in the plan.

We believe that mandatory collective employee benefit plans should be accounted for as defined contributions plans if the following conditions are satisfied.

a. Employers are by law or collective (industry wide) labour agreement obliged to participate in collective employee benefit plans;

b. If an employer cease to employ employees or cease to employ employees that fall under the afore mentioned collective labour agreement or if the employer leaves the collective scheme, it will have no obligation to pay the benefits earned by its employees in previous years and the entity has no legal or constructive obligation to pay those benefits in the future; and,

c. The individual employer does not have significant influence in the terms and conditions of the collective employee benefit plan.

The employer shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from the mandatory collective employee benefit plans. For each separate plan the entity shall disclose:

a. The relevant terms of the benefit plan;
b. The relevant elements of the funding agreement (if any) with the pension fund, e.g. fixed contribution arrangements, maximum contributions levels, frequency of resetting pension contributions, predetermined relationships between funding level of pension fund and contribution level of the sponsoring entities;
c. to the extent that a surplus or deficit in the plan may affect the amount of future contributions;
    i. any available information about that surplus or deficit;
    ii. the basis used to determine that surplus or deficit;
    iii. the implications, if any, for the entity;
d. The measures that the board of the pension plan might take in case of eventually arising surpluses and deficits within the plan; and,
e. Anything else deemed relevant considering the pension plan or pension fund.