COMMENTS

9 July 2008

PAAinE Discussion Paper on Financial Reporting of Pensions

General comments

EFRAG/ASB have prepared a good discussion paper (DP), bringing together the critical conceptual arguments for various approaches to this important area of financial reporting. If our comments below focus on aspects with which we disagree, this should in no way be construed as detracting from the quality of the conceptual exposition.

While EFRAG/ASB have viewed the matter from one conceptual angle, BUSINESSEUROPE had viewed it from other angles and naturally reviewed the outcome from the viewpoints, Does it make practical sense, and does it give more meaningful information to users which is necessary for their purposes? It is in these areas where we have most concerns, discussed in more detail below: these arise from the theoretical focus on assets and liabilities and changes in them, rather than on the presentation of meaningful information on flows of sustainable underlying earnings which is of foremost interest to preparers and users, the primary parties involved in financial reporting. This is also linked to an overemphasis in several cases on legal aspects rather than the underlying economics and expected cash flows, including in areas of measurement where they have less relevance than in the matter of recognition.

Also, it is appreciated that, in some areas such as presentation, EFRAG/ASB were working within an uncertain framework (pending Phase B of the Financial Statement Presentation project.) However, we would have found helpful in several instances greater clarity of their reasoning for favouring one set of arguments over another.

Finally, BUSINESSEUROPE sensed a substantial weight being given to measurement issues. When one considers the length of time over which variations will take place and other factors tending to cause substantial divergences from expectations, it is necessary to keep in proportion the effort needed to be put into measurement, which may be substantially increased – for little practical benefit for users - by the imposition of theoretical, over-sophisticated measurement approaches. Even actuaries make no claims to have found any "right answer" on measurement. Given that the measurement of pension assets and liabilities involves much longer periods and uncertainties than many other assets and liabilities and that the resulting volatility of outcomes can render quite obscure any underlying trends for predicting cash flows, it is not surprising that both companies and pension fund trustees tend to manage on trends rather than on single point-in-time measurements and changes therein.

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Specific comments

Chapter 2, Liabilities to pay benefits

BUSINESSEUROPE agrees that a liability arises when service is given and a present commitment arises. Even for service before vesting takes place, e.g. before the employee reaches a certain age, there may be a constructive or stand-ready obligation on the entity's part. The areas of concern which we have with the conclusions about liabilities lie in:

- an overemphasis on legal rather than economic aspects, with a consequently narrower view of constructive obligations than we believe is justified by the Framework and by IAS 37, and

- a certain confusion of recognition with measurement principles.

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)?

BUSINESSEUROPE does not believe that this is primarily a question of recognition but one of measurement. To use current terminology, an employer (or a separate fund sponsored or otherwise relied upon by the employer) has an obligation to pay a pension in the case of both DB and DC plans. In the first case it will be a pension based on (say) final salary, in the latter on contributions paid, but the obligation to pay a pension is indisputable in both cases. The "slice" of ultimate pension attributable in the former case is not a separate liability but flows into financial reporting via the measurement of the liability to pay the (whole) pension in terms of expected cash flows. Even if the slice were looked at as a separate element, there is generally a constructive obligation present arising out of the entity's past practices. Consequently we believe that expected pensionable salaries must be considered in the amount of the liability: however, that consideration would form part of the measurement of the pension obligation seen as a whole. Inclusion of expected pensionable salaries is also desirable as it gives more meaningful and useful information to users and preparers alike. Also, it is worth noting that liabilities provided for under IAS 37 also consider expected future cost inflation (expected value.)

We have discussed at length what the term "expected pensionable salaries" should cover, bearing in mind that the degree of commitment on the part of the employing entity to increase salaries can be highly variable. Where for instance salary increases in line with an inflation index are unconditionally stipulated in an employment contract, commitment will obviously be high. On the other hand, increases arising from promotions – which may or may not happen in future – do not exhibit this same degree of commitment. Many favour restricting the expected salary increases considered in the measurement of the liability to the level of expected inflation unless clear, specific legal or constructive obligations to provide more exist.

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It may be worth mentioning here the relevance of this point for what are currently termed "defined-contribution plans". Here the present obligation is to pay a certain monetary amount in a period, and this obligation has generally been largely met by the end of the period where the plan is funded: in contrast to final-salary plans there is not already a further variable, as yet undetermined amount needing to be estimated for the pension liability of the period. This is an important distinction in the nature of the obligation and may even necessitate retention of the DC/DB differentiation if this is required to ensure that no complex recognition and measurement are imposed for "simple", plain-vanilla DC plans which can currently be accounted for in a straightforward, understandable and cost-effective manner. The differentiation should, however, be made clearer and more principle-based in contrast to the present artificial rules.

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?

In our view the workforce as a whole should be the unit of account. The pensions liability is, in
IAS 37 terms, one with "a large population of items" rather than a collection of "single obligations". This approach has the advantages that it results in measurement which aligns more closely with the entity's expected cash flows and is thus more meaningful for users and preparers alike and that it reflects the synergies in the portfolio of risks involved.

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

BUSINESSEUROPE agrees but is disturbed that the DP may define this too narrowly in respect of constructive obligations, as discussed above.

Chapter 3, Assets and liabilities: reporting entity considerations

BUSINESSEUROPE believes that adopting the conclusions of the DP in financial reporting would in many instances give less meaningful and less useful information to users, as they do not generally reflect the way in which pension funds fit into preparers' businesses.

We would have liked to have some consideration in the DP of how consolidation rules would actually apply to pension plans. It is not clear to us, for instance, how situations would be dealt with in which employer and employees share control of the plan, so that neither can be said to have control. Similarly, we would like to have had some discussion of the implications for consolidation of pension plans where these hold as assets participations in other entities in the group. Obviously their elimination would make the consideration of the consolidated pensions position per se a rather more difficult process without substantial further disclosure – which itself would call into doubt whether the consolidation approach would indeed give more meaningful information.

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?

While BUSINESSEUROPE accepts this in principle, we have certain concerns. At the centre of these concerns lies the implied gross presentation of pension assets and liabilities which are currently shown on a net basis. This is not primarily a question of control and consolidation but of how the relevant assets and liabilities interact. Even where no separate plan exists, it is conceivable that an entity may effectively ring-fence certain of its assets for meeting its pension obligations and that for all practical purposes those assets cannot be touched for any other use. This may often be the case with German plans. In this situation a gross presentation would give a misleading picture of the entity's financial position. It is unfortunate that current IFRS lay down severe restrictions on net presentation of assets and liabilities and thus prevent in certain cases a more faithful representation of the underlying economic situation. In these circumstances we believe that, even if consolidation of a plan is required because of control by the entity, a practical exemption from gross presentation should be incorporated where the assets involved are closely linked with, and ring-fenced for, the pension obligations. We understand that users are also unconvinced that a gross presentation would give them better information. Since the present arrangements arrive at a similar outcome, we wonder whether a change would make practical sense or bring any tangible benefit.

Chapter 4, Recognition of pension assets and liabilities

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)?

The question of immediate recognition / deferral is inextricably bound up with the measurement model adopted. A model which results in pension asset and liability values which properly reflect their long-term nature may well obviate the need for any deferral mechanism or other procedure for ensuring that information on income trends and flows is not rendered meaningless by short-term capital market volatility. The measurement bases discussed in the DP, based on point-in-time market values, interest rates and returns, do not lend themselves well to this purpose.

As prerequisites to acceptance of immediate recognition of changes in pension assets and liabilities, we see meaningful valuation bases and a practical and sensible way of presenting the effects in the income statement in a usable and meaningful fashion. To give an idea of the importance of this, we quote from Roche's 2007 consolidated financial statements which showed the following for defined benefit pension plans (CHF millions):

- current service cost	361
- interest cost less expected return	74

- actuarial gain on plan assets 495
- actuarial losses on obligations 718

In other words remeasurements overwhelmed the real flows. What is useful in here for the user? Flows and not assets/liabilities are what companies and users focus on. And for the reasons mentioned in para. 1.4 of chapter 5, the level of reliability of estimates of pension liabilities is by no means high, so to what extent can they be said to meet cash flow predictability criteria?

On the arguments for deferral mechanisms in para. 3.3 it must be stressed that points (i) and (ii) relate more to short-term volatility of a very subjective measure in respect of a long-term cash flow, which is also managed for the long term.

On the other hand, the counter-argument in para. 3.4 (i) needs to be placed in the context of high and not very meaningful volatility arising from point-in-time valuations looking many years ahead. On that in para. 3.4 (ii), no one is saying everything will always reverse or we ignore items indefinitely, but we would rather be approximately right with useful information than precisely wrong. On para. 3.4. (iii) and para. 3.5 we must seriously question to what extent a point-in-time value in accordance with the DP's approach is a faithful reflection of the likely impact on the company.

Finally, referring to para. 4.2 on the standard setters' views in 1998, there were clearly many IASC members who did agree that immediate recognition of values such as in the DP was not appropriate, which is why IAS19 was published with a deferral mechanism.

Above all, in short, before any "immediate recognition" can be accepted unreservedly, both long-term measurement methods and the interrelationship with performance reporting need to be satisfactorily resolved.

Chapter 5, Measurement of liabilities to pay benefits

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

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

Regulatory measures may well give economically meaningful information, in the sense required of general financial statements. BUSINESSEUROPE believes 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 principles. Such an alignment could be vetted overall for the individual jurisdiction. This approach could have considerable practical benefits in view of the substantial real costs involved in producing valuations.

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

See next point.

- 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 than by adjusting the amount of the reported liability?

BUSINESSEUROPE supports the proposed focus on entity-specific, rather than market-related, factors for measuring these liabilities. However, we do not find convincing the arguments for using an approach whereby risks are only disclosed statistically and not considered in the valuation. This is quite inconsistent with other IFRS like IAS 36 and IAS 37 – indeed, IAS 37 takes the view that it would be very rare that an estimate cannot be made, and the fact that estimates are currently made under the present IAS 19 suggests that the paper may be exaggerating the difficulties.

On the question of the discount rate, we find it unhelpful that IFRS appear not to have any consistent approach to the general principles of discounting. On the one hand IAS 12 actually forbids discounting of deferred tax assets and liabilities, while IAS 36 and IAS 37 require discounting which takes into account the risks involved in the assets and liabilities under review for measurement purposes. (Perhaps phase C of the Conceptual Framework project on measurement will eventually provide some insight into this matter.) We think it clear that the risks and uncertainties in the pension plan cash flows should be taken into account in measurement of the liabilities (not just described in the notes). While this could be done in risk-adjusting the underlying expected cash flows and applying a discount rate which excludes these risks, we prefer the present approach whereby these risks are considered in the discount rate.

On the question whether to apply (e.g.) an AA corporate bond rate or a risk-free (government bond?) rate, we believe that the former is the more relevant as the pension liabilities are in effect part of the entity's external financing (borrowings from its pensioners and active plan members), on which an equivalent rate must be "paid", inclusive of risk. This view is corroborated by the fact that, in many jurisdictions, pensions regulators require entities to provide levels of security for their obligations.

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

The question of incorporating own credit risk into the current (fair) valuation of liabilities is one which is not restricted to pensions and has bedeviled discussions on financial instruments and other topics. We believe that the question should not be resolved here but as a general principle. (Again, Conceptual Framework project, phase C?) Until such time we would continue with the use of an AA corporate bond rate, without necessarily committing to any general principle of exclusion of own credit risk from liability valuations. When we consider the risks to which the creditors of unfunded plans are exposed from their point of view, there do appear to be some arguments for reflecting own credit risk, but we would like to leave the question open, for full and proper consideration as a general principle.

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

We can agree with this.

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?

To better align with expected cash flows and an economic rather than legalistic view of the entity's position and performance, a probability-weighted approach should be applied. This would also be consistent with a total-workforce approach (Q2. above) and with the "large population" approach of IAS 37.

Chapter 6, Measurement of assets held to pay benefits

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

As with the aspects of liability measurement, recognition of assets and liabilities and presentation in the financial statement, it is in our view neither possible nor sensible to look at the aspect of the measurement of plan assets in isolation. The interrelationship of all these aspects is so close and so crucial for producing meaningful financial information that they have to be considered as a whole. Since the income information related to plan assets is a significant element in the presentation of performance and trends therein, the valuation aspect cannot be divorced from its impact on the presentation of income. The IASB DP on pensions illustrates an awareness of the interrelationship in its various alternative suggestions for income statement presentation. If the latter were based simply on changes in point-in-time asset valuations, the availability of information useful to users would be substantially limited. In particular, if the expected return were no longer to be the basis for presenting the return on plan assets in the income statement, some other way of appropriately reflecting the long-term nature of the asset position in the income impact would need to be determined. (See also Q10. below.)

We are in any case somewhat puzzled by this chapter. Elsewhere, the DP asserts that its objective is to base principles of pension accounting on principles in general standards. However, the general standard for financial assets considers not just current (fair) value as a measurement basis but, for certain categories of assets, an amortised cost basis, e.g. for held-to-maturity securities. Since the latter is a category which could well be relevant to pension assets in many circumstances, we do not understand why the general principle is not applied here.

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Chapter 7, Measurement of employer interests in assets and liabilities of trusts and similar entities

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 with this. However, the divergences which may arise because of the asset ceiling are an important caveat, as the detailed exposition in the DP makes clear.

Chapter 8, Presentation in the financial statements

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

Apart from the matter of measurement approach, a satisfactory solution to the presentation of pensions is also totally dependent on a satisfactory solution to the presentation of performance in general. A leading financial analyst recently expressed considerable regret that, through its changes in recent years, the IASB has made the income statement less and less useful for users without substantial adjustment. A key factor – in many ways for preparers too - is the ability to discern "sustainable underlying earnings".

So that our starting-point is unmistakable, we stress that – while, according to para. 7.11, the IASB and FASB recognize the elimination of OCI and recycling as a long-term goal – this is absolutely not a goal which preparers share. Indeed, its attainment would be more than likely to lead to non-GAAP information becoming the central point of communication between preparers and users, and this can surely not be in the interest of the standard setters. We must also say that, should the approach outlined in the discussion paper be adopted, we could in no way subscribe to the assessments made in paras. 7.12 and 7.13: financial statements would be dis-improved in respect of understandability, meaningfulness and usefulness.

Are actuarial gains and losses helpful for identifying sustainable underlying income? This leads us back into the whole debate on disaggregation (recurring/non-recurring, operating/investing/financing, realized/unrealized, re-measurements/other) and on re-cycling. As usual some may argue that this information can be given in disclosures. However, for users as for preparers, we believe that a structuring along the following lines would be the most helpful form:
- current-year service costs in operating profit,
- discount unwind and some meaningful form of return on plan assets in investing/financing profit,
- the rest in OCI (components to be disclosed.)

We are aware that the cohesiveness principle being worked on in the Financial Statement Presentation project may result in a different classification, e.g. all income-statement items being shown together in operating. We await the outcome of these deliberations.

With regard to “some meaningful form of return on plan assets”, we would aim for a measure which properly reflected the long-term nature of the asset position of the plan. For all its shortcomings the expected rate of return goes a long way to achieving this, and we believe that, if it is to be replaced in its present form, users would receive the most useful information if ways could be found of adapting it so as to meet some of its opponents' objections but still retain its long-term orientation.

Since we would like to see all income and expense going through P&L at some time, we favour recycling the elements first reported in OCI: experience adjustments and changes in non-financial assumptions over the period remaining till retirement, changes in the discount rate and other elements in the return on plan assets over the expected duration of the liability. However, even here, a clear separate presentation of the recycled amounts, to enable focusing on the flows relevant for the year being reported, would be necessary. The present alternative of leaving actuarial gains and losses in OCI could be allowed as an alternative presentation. Insofar as a standard does not allow for the above and for the necessary disaggregations in the performance statement itself, the focus will further shift away from financial statements to non-GAAP measures. This would naturally have negative consequences for consistency, comparability and understandability as well as limiting relevance.

As confirmed in the Basis for Conclusions of SFAS 158, “... the past practice of delaying recognition of gains and losses as a component of net periodic benefit cost, reflecting the long-term nature of post retirement benefit arrangements. Furthermore, that treatment is consistent with the practice of including in other comprehensive income certain changes in value that have not been recognized in earnings (for example, unrecognized gains or losses on available-for-sale securities).”

Q11. Do you agree that 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?

See response to Q10 above, in which we argue for a “meaningful form of return on plan assets”, of which expected return is one possibility.

Chapter 9, Disclosures in the employer's financial statements

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?

It is difficult to comment on disclosures without a clear knowledge of the information to be presented in the financial statements themselves. We here assume the basis outlined in the DP, although we by no means fully accept that (see chapter 8 above.) While the information on risks and rewards and obligations is clearly important for users, we believe that the paper places insufficient emphasis on information – whether in the financial statements or in the notes – about the flows involved with pension funds sufficient to allow users to form a judgment about the sustainable underlying earnings of the entity. This should be available from the financial statements, but insofar as that

is not the case disclosure of this particular information seems essential. We fully understand users' interest in (e.g.) sensitivity analyses, real cash flow profiles, average maturities of obligations and buy-out values, in regulatory measures of assets and liabilities of major plans, in details of employers' funding agreements with trusts and in indications of average maturities of liabilities and are open to the incorporation of such information.

Nevertheless, we have an important caveat, namely on information overload. In general the pensions note in most annual reports is already quite extensive, and the more information that is added, the less understandable and digestible it will become. It will therefore be essential for choices and trade-offs to be made so that disclosures focus on just a few key items of information. These problems on disclosure become most acute where a large group has a substantial number of separate plans. Hence, for pragmatic reasons, we would urge that any disclosure requirements which do not already derive from the consolidated figures should be focused on material plans. Input from users should be sought to identify what information in addition to the financial statements themselves is of most use to them.

As an additional point on disclosures, we think that these should be oriented to investors as users. The needs of plan members are met by the reports of the individual plans which are generally defined on a local level.

Chapter 10, Accounting for multi-employer plans

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's plan? How, in your view, should an accounting standard require that this be implemented in practice?

As a generic principle the suggested approach appears reasonable. However, there are several aspects which lead to the conclusion that the generic principle needs to be finessed in certain circumstances.

The major stumbling-block which needs to be taken into account is the availability of meaningful information for the individual entity's position. It is very often the case that information giving a faithful representation of its rights and obligations under the plan – as opposed to a mere statistical allocation - is not available. In such circumstances attempting to apply the generic principle will not produce values which users of the financial statements can rely upon. Here, a treatment similar to the present defined-contribution approach would be most appropriate.

Further, given the wide diversity of such plans, the principles need to be finessed to ensure that they do not lead to meaningless outcomes in particular circumstances. We cite the example of Dutch compulsory industry-wide multi-employer pension schemes as a typical situation where the dogmatic approach would lead to such outcomes. Bearing in mind their specific characteristics, these schemes – when looked at as a whole – bear far more resemblance to state pension schemes, which are currently treated in effect as defined contribution plans, than to single-entity schemes. As with

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state plans, these collective plans are not subject to control or influence by the individual reporting entity while the only obligation of the individual entity is to pay the contributions as they fall due. Like in state plans, 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. Thus the allocation of plan assets and liabilities to individual employers leads to meaningless values in terms of the individual employers' current rights and obligations and cannot be regarded as giving a faithful representation of the employer's position. A more realistic solution needs to be provided for such circumstances, as US GAAP currently recognises in its approach to such plans.

Chapter 11, Financial reporting by pension 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?

Since the financial reporting of pension plans by the employing entity and that of the pension plans themselves are such different animals, with the informational needs of plan members diverging in so many respects from those of the users of the employing entity's general financial statements, we find it unfortunate that the latter topic has been treated in the same paper. However, we would like to make the following points.

This section of the DP includes a number of valid points on the reporting by pension plans such as:
1. plan members may require different information from that in the employer's financial statements which serve different needs;
2. pension plan reporting tends to be influenced by regulatory requirements which in turn focus on funding and solvency;
3. stewardship is a key issue for reporting to members.

However the conclusions drawn are not appropriate, and in particular the following points must be considered:
1. it is difficult to see who the plan reports are for other than its members - companies and regulators will either ensure the reports contain what they need or get it directly;
2. the broader range of users of financial statements mentioned in para. 4.2 are not relevant in the context of plan reports;
3 therefore general purpose financial statements are not necessarily relevant in this context;
4. similarly there is no reason why plan reports should have to be consistent with IFRS financial statements, let alone have to comply fully with IFRS including disclosures.

It seems reasonable to include some measure of liabilities as well as assets in plan reporting. However the key point is that members are primarily interested in how their benefits will be paid in the future and the actions being taken by the plan trustees, the company and the regulator to ensure this happens. The reporting to members should

therefore focus on the approach used as the basis for regulatory requirements, explaining the funding position, the investment strategy, the employer covenant etc. It will also tailor the reporting to the specifics of each plan, which seems more meaningful. Likewise, we do not see why the fact that regulatory regimes will vary between countries is an issue. Finally, we should not then make the reporting more complex and confusing for plan members by requiring a number of other measures of funding to be disclosed.

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?

See answer to Q14.

General questions

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.

Please refer to our comments on multi-employer plans under Q13 above.

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?

BUSINESSEUROPE knows from experience how many questions of practical application arise on the financial reporting of pension plans by employing entities and trust that any final standard should have sufficient clarity in its principles to minimize such doubts and difficulties. From past experience we list the following as additional areas often giving rise to issues:

- Treatment of non-salary related benefits
- Recognition of death and disability benefits (implication that these are not present obligations until death or disability occurs)
- Settlements, de-recognition of liabilities
- Treatment of unpaid contributions
- Asset ceiling
- Members' purchases of additional benefits

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