MERCER

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14 July 2008

Technical Director
Accounting Standards Board
Aldwych House
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Dear Sir

Subject: Discussion Paper - The Financial Reporting of Pensions

I appreciate the opportunity to comment on the discussion paper on behalf of Mercer.

We have seen many changes to accounting standards dealing with pension liabilities over the last few years and further changes are in the pipeline. In particular, we note and support immediate recognition in the company balance sheet of actuarial gains and losses since this provides a transparent view of pension liabilities. Following these changes, we believe that the accounting basis for pensions will provide a realistic picture of the impact of pension schemes on their sponsoring companies.

Our comments on the discussion paper focus largely on the practicalities of implementing some of the suggestions made:

- We agree that similar principles should apply to accounting for defined contribution and defined benefit plans, but consistency and comparability will not be achieved unless a clear guideline is provided on the minimum acceptable level of attribution
- In our view, the current basis for the discount rate, AA-rated corporate bond yields, is a reasonable basis for discounting pension debt. Though there are practical problems with using AA-rated bonds, the argument for moving away from this measure is not compelling.
- Using the actual return on assets for the presentation of pension expense in the profit and loss account means that the most significant source of actuarial gains and losses for many plans will directly impact annual company earnings. We believe this provides a misleading picture of the effect of pension plans. However, we support the use of the discount rate instead of an expected return for calculating an income figure to offset the interest cost.

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Our responses to the specific questions in the discussion paper are provided in the appendix.

We appreciate your consideration of these comments and those in the appendix. If we can provide any assistance or further clarification, please contact me on 01243-522560 or via e-mail: phil.turner@mercer.com.

Sincerely,

Phil Turner

Phil Turner
Mercer Global Financial Reporting Standards Group

Appendix

***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 decision to increase an employee's salary creates an additional cost for the employer in the period in which that decision is made. The financial statements should reflect whether the employer has revenues to cover the additional cost of increasing a salary, regardless of whether that cost is direct cash compensation, or deferred compensation such as a pension. Therefore we believe that the correct measure of the market value of pension liabilities is based on current salaries (please also see our response to questions 2 and 3).

***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 consider pension benefits to be part of the compensation paid to an employee for the employee's service. Financial reporting should therefore be based on the premise that liabilities are owed to an individual. The consequence of this view is that costs for an individual should not be spread over the workforce as a whole.

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

We believe "present obligations" are the benefits that would be provided by the company if the pension arrangement were closed. This may not always be a clear definition, and a more practical definition which achieves broadly the same objective would be to consider "present obligations" as the benefits accrued in accordance with the accrual formula without regard to vesting. This is a suitable starting point for the definition of liabilities, but it will not be an adequate definition in all circumstances. For example, some plans do not provide an accrual formula and others are excessively back-loaded. The discussion paper anticipates that in such circumstances an obligation will be recognised based on a "constructive obligation" that goes beyond the terms of the plan. In our view, this is not an adequate definition of liability

for these plans. A minimum basis of attribution would therefore be required. This needs further consideration.

***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 note that pension plan assets can in many cases be differentiated from other company assets in that the company has no use of the assets until the corresponding liabilities are eliminated.

***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 support immediate recognition in the company balance sheet of actuarial gains and losses since this provides a transparent view of pension liabilities.
We do not support immediate recognition of actuarial gains and losses in the profit and loss account at this time. We note that projects are underway to redefine accounting presentation, and the results of those projects are critical for defining how gains and losses are treated. We also note that immediate recognition of gain and loss is currently provided through SORIE (IAS) and OCI (FASB), and believe that those approaches are reasonable until the financial statement presentation projects are complete, and an informed analysis of how pension gains and losses relate to other items in the new income statement can be completed.

***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?

Yes. General accounting principles would include not recognising a pension surplus as an asset if the company believes it will derive no benefit from this.

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

No. For example, if in the UK the PPF levy is charged to the profit and loss account, it is wrong to treat the balance sheet item as risk free. It is preferable for investors to have a consistent measure so the liabilities of different companies are directly comparable. Given the mix of funded and unfunded schemes to which pension accounting standards apply, the use of AA-rated corporate bonds seems reasonable. In the absence of a widely-recognised alternative, we see no compelling reason to move away from the use of an AA-rated corporate bond yield.

We note that there are difficulties in the choice of a suitable discount rate based on AA-rated corporate bonds. These include the choice of a bond or index, adjustment of the reference yield for the timing of the projected benefit payments, and distortions of financial markets such as that caused by the current credit crisis.

The use of a risk-free discount rate at the present time would place pension liabilities on a different footing to other items in the company balance sheet – most notably the value of its own corporate debt. This would exaggerate the significance of pension liabilities in the balance sheet.

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?

In general, yes. Please note our comments about discount rates.

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

We agree that company-specific credit risk should not be reflected, but we believe it is reasonable to make a general allowance for credit risk as discussed above. Investors should be left to make their own adjustments for company-specific risk.

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

Expenses of administering the plan that are met directly from the plan should be recognised as part of the pension expense. This is typically achieved either by adding expected expenses to the current service cost, or deducting them from the expected return on assets (or a comparable assumption). We see no particular advantage to either approach.

We see no compelling reason to capitalise future expenses for an ongoing plan, although such capitalization may be appropriate for a frozen plan. The increase in liability that would then occur as a result of freezing would represent the increased burden being borne by an employer which must now administer a plan that is no longer related to the revenues being generated by employees.

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 at an amount that reflects the probability of different outcomes.

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

Yes

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?*

Yes, though assets which generate income that exactly matches specific benefit liabilities should be valued on a comparable basis.

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

We see no compelling reason to move away from the general format for presenting pension expense that is used currently (current service cost, interest cost, expected return on assets, actuarial gain/loss). Investors are now familiar with this format and important information is provided about accrual costs, financing costs, and re-measurement items, but see also our answer to question 11 below.

We agree with the comments in the recent IASB discussion paper about the different "predictive value" of ongoing and re-measurement items and consider that these should be separated between profit and loss and other comprehensive income as under FAS 158,

FRS 17 and the immediate recognition (SORIE) option under IAS 19. We have no particular view about whether the latter should be "re-cycled".

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?*

We agree that overall financial performance of an entity should reflect actual return. However, as discussed in Question 5, overall financial performance consists of a variety of categories of income, and until those categories are (re-)defined in the accounting literature, speculating as to in which category each of the components of pension expense should be placed is not productive. We note, however, that the actual return on assets incorporates the most significant item of actuarial gain and loss for many plans. Including this highly volatile item in operating results presents a misleading picture of the impact on the company and has the potential to create more opacity, rather than less, when it comes to understanding the fundamental profitability of the company. We believe it is better to identify asset gain/loss separately.

We note the concerns about the potential abuse of an "expected return on assets" assumption. We also note that the "expected return on assets" can deter sensible risk-management of pension liabilities because of the impact on the current assumption.

To the extent that asset returns are part of operating results, we believe that an imputed return based on the discount rate should be used. This would allow the separate items "interest cost" and "expected return on assets" to be combined into a single item "interest on surplus or deficit". This would also provide a consistent basis for dealing with defined contribution plans.

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 are in general agreement. However, we believe pension disclosures are already excessive for many companies, and a materiality exemption could be considered.

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. While we agree that at a theoretical level it would be desirable to apply similar principles, in reality the determination of the employer's obligation to the multi employer plan is often not determinable to an accurate level. Employers in a multi employer plan generally share the risk with other employers and attributing the appropriate risk to an employer is complex. As the discussion paper notes, the ability to obtain information is often difficult or not timely.

This topic warrants separate consideration.

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 that members of a pension plan should have some means of assessing the security of their benefit promises. However, accounting standards would be useful only where this is not already covered by legislation.

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?*

No. One could argue that under the laws of many countries, an employer is covenanted to fully fund all plans at some point. This would imply that, except for the effect of employer credit risk, all plans would be shown as fully funded. This does not provide useful information to the participants. The better answer is to show assets currently held by the plan, and describe in a footnote any employer covenants for future funding.

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.*

We believe that consideration should be given to the value of options and guarantees built into a pension plan.

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 comment.