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VIA EMAIL

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Re: PAAinE Discussion Paper on Pensions

Bedum, 14 July 2008

Dear Sir/Madam,

I appreciate that all relevant stakeholders including the general public have the opportunity to respond on the Discussion Paper "Preliminary Views on amendments to IAS19 Employee Benefits" (hereinafter referred to as "DP"). It is clear that EFRAG/ASB has done a thorough job in delivering the DP, and I am convinced that several stakeholders to financial reporting will respond back to EFRAG/ASB.

Please find attached my comment letter to the PAAinE Discussion Paper on Pensions. Although I'm working for a pension administrator as CFO and I lecture on pension accounting, this letter is sent to you on personal title.

In the Invitation to Comment several questions are raised. However, my comment relates as an answer to Question 16 primarily to chapter 7 of the DP, as I see a significant incompleteness in that specific chapter. In my comment I will refer (in bold italics) to some other questions in relation to this part of the DP.

I trust that with the DP and all the responses, ASB and EFRAG and IASB can move forward to making IAS19 a better standard, both conceptually and in acceptance by stakeholders.

Yours sincerely,

Mr. Anne Laning

1. Introduction

Chapter 7 of the DP is about whether the use of a trust or a similar legal entity (hereafter: a pension fund) changes the accounting on pensions by the employer. The DP concludes that this is not the case, because also when the pension liability and the pension assets are within a pension fund, it is the employer who guarantees that the pension liabilities are met, and therefore is exposed to all the risks attached to the liabilities and assets. This is clearly stated on page 167 of the DP: "the employer has an obligation to fund any shortfall should the assets held by the trust be insufficient to settle the liability to pay benefits". For multi-employer plans, this assumption is also made, for example by stating liability B in the table on page 210 of the DP.

This guarantee of the employer may be the case for several pension funds or even obligated in some jurisdictions, it is however not universally the case. At least in the Netherlands, the following situations can apply:

- The employer is obligated to fund part of the shortfalls of the pension fund within a specified period of time, and in the meantime the increases of the accrued pensions and the pensions in payment to price and/or wage inflation (indexation) are lowered or even absent. This is the concept of conditional indexation, a strong mechanism to share the pension risks between the employer (rising premiums) and the employee (lower or no indexation, and possibly also a higher premium), the deferred member (lower or no indexation) and the pensioners (the same). Depending on the maturity of the fund and the premium policy, this mechanism can in fact mean that the majority of the risks is borne by the active and deferred members and the pensioners¹.
In most cases, there is no separate premium for the funding of the shortfall. Instead, a new premium percentage is decided on by the board of the pension fund (outside of control of the employer) which consists of (inseparable) the funding of the service costs for one year (based on the board's evaluation of the funding position and expectations of the future), and the eventual funding of the shortfall, and the eventual funding of the indexation ambition.
- A special case of this risk-sharing mechanism exists with industry-wide pension funds. Employers within a specific industry participate in these funds, and are exposed to the above risk sharing mechanism. However, if an employer ceases to participate in the fund (for example because of a change of business activities), no liabilities to fund any shortfalls exist. Also, new employers in the industry face the funding of any shortfalls existing at the moment of their participation. This is because the pension fund uses one single premium percentage in a given period, payable by all participating employers (and partly by the employees), irrespective of the specific population of each employer (average age, period of service etcetera) or the duration of participation. No one-offs in premium exist, or entrance or exit fees. In this way, the pension fund exposes the participating employers to actuarial risks associated with the current and former employees of other employers.
- The employer has no obligation at all to fund the shortfalls of the pension fund. Shortfalls must be recovered by reducing the indexation to the active and deferred members and the pensioners. In the end, even the existing rights of the active and deferred members and the pensioners can be reduced.

¹ From a sample of 500 funds, on average, a 1% increase in premium equals on average 0.06% of assets and 0.08% of liabilities, so a reduction of the indexation of 1% is around 10 to 15 times more effective than an increase of the premium by 1%.

Important to note that the pension fund is not controlled by the employer: the employer may by law appoint no more board members than representing 50% of the voting rights. The discretionary authority of the board may also not be limited by contracts.

It is clear that with the use of an independent pension fund in combination with risk sharing, the funding position of the pension fund, both in terms of amount and riskiness of the assets, influences the amount of the liability for the employer. Accounting for the full value of assets and liabilities (even on a net basis) doesn't give a true and fair view of the employer's obligation and risks².

For this reason, the discussion within chapter 7 must be expanded and generalized to accommodate also the above situations. This concerns three aspects: the definition of a liability, the presentation of the liability, and more specifically, the measurement of the liability.

2. Definition of liability

The conceptual framework defines a liability as follows:

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Also, an obligation is something an entity cannot avoid, and it can be measured reliably.

In case the execution of the pension promise is placed within a pension fund, the only obligation of the employer is the payment of the premiums (at least in the Dutch context). Premiums to be paid in future for future years of service do not match this definition because they are not present obligations.

Q3: In my opinion, recognition of a liability can only occur in three instances:

1. When a pension promise is not placed in a pension fund, so there is an obligation to pay pensions to the pensioners due to past service.
2. When a pension promise is placed in a pension fund, but it is not fully funded by the rules of the pension fund, so there is still an unavoidable obligation to pay further premiums in respect of past service.
3. When an employer is exposed to risks attached to pension liabilities and pension assets that are placed within a separate pension fund, in such a manner that there is a reasonable chance that the employer is forced to pay additional premiums that are attributable (and separately measurable) to past service.

Situations 1 and 2 are obvious. For situation 3 additional guidance on presentation and measurement are needed, which is discussed below. From this list it is clear that if in one year only premiums are being paid for the (varying) service cost of that year, no liability arises because the past event is missing.

² **Q5:** With the current possibilities of smoothing (corridor and deferred recognition) this problem is "hidden" in the accounts, in such a way that the resulting figures are in a sense an approximation of the real figures. Immediate recognition of the changes in assets and liabilities would adversely impact the quality of the accounts.

3. Gross or net presentation of pension liability

In my opinion, the decision flow regarding the presentation of the liability must be as follows to be complete:

1. Where does the obligation to pay the pension benefits reside?
 - a. With the employer.
 - => It is assumed that the employer bears all the risks attached to the pension liabilities and pension assets.
 - Are assets solely available for meeting the pension liabilities, in the sense that these assets are not available for creditors in the event of bankruptcy (for example in a dedicated fund, or otherwise sufficiently ringfenced)?
 - i. Yes.
 - => Net presentation of pension liabilities and pension assets.
 - ii. No.
 - => Gross presentation of pension liabilities and pension assets.
 - b. With a separate legal entity like a trust or a pension fund.
 - Does the employer control the separate legal entity (**Q4**: based on the usual principles for consolidation)?
 - i. Yes.
 - => Consolidate the legal entity, go to 1.a.
 - ii. No.
 - => It is assumed that the assets are solely available for meeting the pension liabilities, in the sense that these assets are not available for creditors in the event of bankruptcy. In that case: net presentation of pension liabilities and pension assets.

The conditions of IFRIC14 must still apply on the net value of pension obligations and pension assets.

4. Measurement of pension liability

Q9: Where the employer bears all the risks attached to the pension liabilities and the pension assets, I agree with the DP that separate measurement of the liabilities and the assets is the preferred approach. This is the (assumed) case in the situations 1.a.i, 1.a.ii and 1.b.i from the above decision flow. However, this need not be the case in situation 1.b.ii. Here, a second decision flow is needed:

2. In the event of a bankruptcy of the employer, or if the participation of the employer in the pension fund is terminated, does the employer (or a legal entity controlled by the employer) has any pension obligations towards the employees or to the pension fund (for example the payment of the pensions, or the funding of a shortfall (but not the normal premium payments))?
 - a. Yes.

Who bears to the risks attached to the pension liabilities and pension assets?

 - i. Only the employer.
=> Separate measurement of the pension liabilities and pension assets in accordance with IAS19 (and the proposals in the DP).
 - ii. Only the active and deferred members and the pensioners.
=> The pension obligation for the employer must be measured to an amount equal to the existing pension assets. As the net obligation is therefore by definition zero, apply DC-accounting with sufficient disclosure on the terms and conditions of the pension plan and the funding mechanisms.
 - iii. Both the employer and the active and deferred members and the pensioners.
=> The pension liability must be reduced to take into account the risk sharing with the present and former employees. There are different methods for doing so, as described below.
 - b. No (**Q3**: the liability is avoidable, there is no obligation in the contract between the employer and the pension fund to pay additional premiums that are attributable (and separately measurable) to past service).
=> No pension obligation for the employer to be recognised. Use DC-accounting with sufficient disclosure on the terms and conditions of the pension plan, the funding mechanisms and the actual funding position of the pension fund. **Q13**: this will usually be the case for Dutch multi-employer plans.

Q6: The situations 2.a.i, 2.a.ii and 2.b can be applied using the current guidance in IAS19 (and the proposals in the DP), however, situation 2.b must be made more explicit. Situation 2.a.iii has not been dealt with by IAS19 or by the DP. Continued thinking in The Netherlands has not yet resulted in consent on the measurement approach. The following options exist:

1. If "a" is the part of the risk that the employer runs (taking into account also the part of the total premium that is paid by the employees), the pension obligation of the employer equals to:
$$\text{pension assets} + a \times (\text{gross pension liability} - \text{pension assets}).$$

If "a" is zero, the pension liabilities are equal to the existing assets in accordance with situation 2.a.ii above. If "a" is 100%, the pension liabilities are untouched in accordance with situation 2.a.i above.
This methodology requires "a" to be known, and despite the simplicity, in the Dutch context "a" is not known and also not fixed for a specific pension plan. Mostly, "a" is dependant on the actual funding position and the maturity of the pension fund.
2. Increase the discount rate for the liabilities with a asset mix based risk premium consistent with the level of risk the current en former employees run (with the exception of the credit risk of the employer). The risk premium added to the normal discount rate would then be ("a" is the part of the risk that the employer runs (taking into account also the part of the total premium that is paid by the

employees)):

$(1-a) * (\text{expected return on assets} - \text{normal discount rate})$

Please bear in mind that this does not incorporate a reporting entity specific element in the valuation, such as the credit risk of the reporting employer. Only incorporated is the risk for the current and former employees, that will lower the obligation for the employer.

As in the previous option, this methodology also requires "a" to be known.

3. Use option valuation methods or scenario analysis (like Monte Carlo simulations). The disadvantage of this is that it requires the full pension plan and the funding mechanism to be fully specified, that only specialists can carry out the calculations and interpret the outcomes. At least in the Dutch context the full pension plan and the funding mechanism isn't fully specified, because several key decisions are at the discretion of the board of the pension fund (outside control of the employer). Examples are the determining of the premium (percentage of pensionable salary) and the granting of indexations.
4. Calculate the pension liability as the discounted value of the future premiums payable by the employer (net of the part payable by the employees) minus the service costs.
This is similar to the approach taken by IFRIC14 to determine the asset ceiling. The same methodology can be applied for a liability ceiling: if according to the rules a net liability exists, but the employer never has to pay for it or has to pay less (because the risk is in part or whole also born by the current and/or former employees), there is no or a lower obligation for the employer.
As in current IAS19 calculations the service cost is already calculated, and each pension fund has calculations of the expected future premiums, this looks like a viable solution.
5. Calculate the present value of that part of future premium increases that arise from past events (if separable) and is due by the employer (excluding the part that the employees have to pay), over a time horizon that the premium can reliably be estimated. Because of the discretionary authority of the board of the pension fund to decide on the premium this can be a short time horizon.

As the specific situations of a pension plan may differ, several methods must be allowed to accommodate the variety of pension plans and funding mechanisms worldwide. The principle is more important than the exact rule, for the financial statements must account for the actual obligation of the employer.

Q11: Please also note that in this situation 2.a.iii, there is no place for an actual return on assets, because the investment risk is shared with the (former) employees.