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PAAinE Discussion paper 'The Financial Reporting of Pensions'

Dear Stig, dear Ian,

On behalf of the German Accounting Standards Board (GASB) I am writing to comment on the PAAinE Discussion paper 'The Financial Reporting of Pensions'. We appreciate the opportunity to comment on the discussion paper.

We welcome the PAAinE initiating a comprehensive debate on "The Financial Reporting of Pensions" which is intended to integrate views of users, preparers, auditors, standard setters and other groups involved in financial reporting. In our view, the PAAinE discussion paper on Pension Accounting represents an effective and valuable contribution to a process of developing a high quality principle-based model. Notwithstanding this fact, we do not share all conclusion reached in the discussion paper.

Please find our detailed comments on the questions raised in the Discussion Paper in the appendix. Should you or your staff have any questions on our comments, please do not hesitate to contact us.

Yours sincerely,

Liesel Knorr

President

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Appendix – Answers to the questions of the discussion paper

Chapter 2: Liabilities to pay benefits

Question 1
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)?

With respect to final salary plans, the German Accounting Standards Board (GASB) is of the opinion that the corresponding liability recognised to pay benefits should be based on the current expectations of employees' pensionable salaries.

- The GASB believes that the liability to pay benefits should only be recognised if the employer is presently committed. However, we point out that there is a difference between final salary plans and other plans which are not linked to the final salary. As regards final salary plans we believe that the employer is obliged because there is a contractual basis for requiring consideration of any future salary increase, and the employer cannot realistically avoid granting competitive pay increases. At least, it can be argued that a constructive obligation exists. The only way for the individual employer to avoid granting future salary increases is to lay off the individual employee. Additionally, in Germany a lot of employers are subject to collective wage agreements between unions and employers' associations or individual employers. In these agreements the parties regularly agree upon salary increases for a whole industry.
- Our above conclusion to include expected salary increases is conceptually consistent with the proposed treatment for unvested benefits (i.e. benefits for which the employee's right to receive benefits is conditional on completing a specified period of future service). In such cases the Discussion Paper (see paragraph 3.23) comes to the conclusion that a present obligation exists because an employer cannot realistically avoid his promise. The liability which arises when service is provided includes benefits in respect of services provided before vesting. Just as is the case with a final salary plan, the only way to avoid the promise's vesting is to lay off the individual employee. Therefore, both cases have to be treated equally. Otherwise, there would be a conceptual flaw.
- Moreover, it is also raised that from an economic perspective salary increases should be included in the present obligation because a potential purchaser of the whole entity would also take into account such increases as plans which are linked to the final salary are more of an economic burden than plans which are not.

Based on the following arguments a minority of GASB members takes the view that the liability to pay benefits should not be based on expectations of employees' pensionable salaries.

- These Board members assume that the liability to pay benefits should only be recognised if the employer is presently committed. They argue that there is no present obligation as long as the employer can avoid increasing pensionable salaries in whatever way (e.g. by laying off the individual employee). Thus, even future salary increases which are a compensation for inflation, should not be included in the measurement of the liability.

- They underline that the recognition and measurement of any kind of liability should be based on consistent principles and that considering salary increases would not reflect the liability 'as of today'. They propose that a final salary plan (i.e. future salary increases are at the discretion of the employer) does not differ from any other plan in which an employer has discretion to vary pension benefits (see paragraphs 4.12 – 4.24). Neither salary increases regarding final salary plans nor any other discretionary increases should be reflected in the measurement of the liabilities and, thus, be part of the expenses that are recognised as services are provided. Proponents of this view accept that, accordingly, the discount rate should be represented by a real interest rate excluding any inflation.

Question 2
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?

The GASB holds the view that for recognition purposes it makes a difference whether a liability is owed to an individual employee or to the workforce as a whole. To respond to the question it is also of importance whether the entity has little, if any, discretion to avoid settling an obligation. The GASB believes that one can avoid settling an obligation with an individual employee, but one cannot avoid settling all obligations with the whole workforce representing a homogeneous population. Thus, to reflect the economic burden of the entity in the financial statements, it is necessary that a liability be recognised. Therefore, as far as the pension obligations are similar across employees, the GASB is of the opinion that recognition should be based on the premise that a liability is owed to the workforce as a whole.

Regarding the measurement of pension obligations, the GASB is of the opinion that pension obligations, like any other obligation, should be measured on a portfolio basis reflecting the best estimate or expected value, rather than promise by promise.

Question 3
Do you agree that recognition should be based on the principle of reflecting only present obligations as liabilities?

As mentioned above, the GASB share the view that an essential characteristic of a liability is that the entity has a present obligation (including constructive obligations) arising from a past event. Therefore, it seems to be consistent that recognition should also be based on the principle of reflecting only present obligations as liabilities.

Chapter 3: Assets and liabilities - reporting entity considerations

Question 4
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 disagree with the view that the consolidation of pension plans should be subject to the same principles usually applied in determining whether consolidation is appropriate.

- The GASB believes that the net presentation required by IAS 19 provides more useful information to the users of financial statements than the suggested gross presentation because the former enables users to identify plan assets that are segregated to fund pension benefits and are not available for other purposes. Were the financial statements of the pension plan consolidated as part of the group financial statements then assets of the plan would be combined with other financial assets of the employing entity that are not held for (and thus limited in their use to) one specific purpose.
- The authors of the Discussion paper argue that gross presentation provides greater information about the resources an entity controls and should, therefore, be preferred. In principle, we agree with this general statement, but in our view this is not the main focus of a user of financial statements who analyses pension obligations. The user of consolidated financial statements is not primarily interested in getting information on how much control an entity has about the segregated plan assets, rather than getting information on the extent to which the pension plan is funded. In this respect, gross presentation provides less useful information than net presentation. Therefore, we support a net approach (i.e. the entity recognises its entire obligation as a liability after deducting the fair value of the assets held by the fund, and makes disclosures of the gross amounts).
- Last but not least, the IASB consolidation project and the Framework project phase D discuss different working definitions of “control”. Due to the stages of the respective projects these definitions might still change and therefore result in different conclusions on consolidation of pension plans.

Chapter 4: Recognition of pension assets and liabilities

Question 5
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 GASB shares the view that deferred recognition for defined benefit promises and the corridor approach should be removed. Full balance sheet recognition for all pension promises is appropriate. In any case, removing the various options currently permissible under IAS 19 should significantly improve comparability of financial statement information between entities.

Chapter 5: Measurement of liabilities to pay benefits

Question 6
Do you agree with the paper’s views in the measurement of liabilities to pay benefits? In particular, do you agree that:
a) Regulatory measures should not replace measures derived from general accounting principles?
b) The discount rate should reflect the time value of money only, and therefore should be a risk-free rate?
c) 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?

d) The liability should not be reduced to reflect its credit risk?
e) Expenses of administering the plan's accrued benefits should be reflected in the liability?

a) We agree that regulatory measures should not replace measures derived from general accounting principles because regulatory measures are driven by other principal purposes (e.g. solvency of pension plans by specifying a level of assets that must be set aside in separate funds to be available meeting the obligations to pay benefits).

b) We believe that a measurement attribute for a pension obligation, as for any other obligation, is to give users of financial statements useful information about the amount, timing and uncertainty of future cash flows resulting from the pension promise. For this purpose an entity-specific measurement approach should include the following characteristics:

- an estimate of the future cash flows,
- the impact of the time value of money, and
- the impact of certain risks.

In our view the future cash flows should be adjusted to reflect the uncertainty associated with future cash flows in order to convey decision-useful information to users. Especially the following risks should be taken into account: asset-based risk (i.e. risk that the liability for benefits promised will fluctuate because of changes in the value of the assets linked to the promise), demographic risk (in particular longevity risk) and also the risk that the amount of pension benefits will differ from today's expectations (regarding credit risk see our response to Question 6d). Provided that the expected value of the cash outflows is adjusted to consider any inherent risks, it is conceptually justified to discount these cash outflows using a risk-free market discount rate.

c) We hold the view that information about the "riskiness" (in the meaning as laid out in question 6) of a liability is best conveyed by adjusting the amount of the future cash flows (see response to Question 6b).

d) Changes in own credit risk should not be considered in the measurement of pension liabilities as the entity has no valid settlement alternatives to realise such changes. If the obligation is intended to be settled by running off the liability (i.e. by making payments to the counterparty as they fall due), no credit risk should be included in the measurement because in this case the liability is not impacted by the employer's individual credit risk (i.e. assuming the entity will continue as a going concern, the employer has to pay the same amount of money regardless of his own credit risk). The same applies when the employer intends to transfer the liability to a third party (immediate buy-out). The buyer's future cash flows resulting from the assumed liability are not impacted by the employer's credit risk and, thus, the buyer will not be willing to consider the employer's credit risk in the purchase price of the liability. Of course, it could happen that in connection with such a substitution of the obligor the beneficiaries accept a reduction of their pension benefits to receive their pension claims from a counterpart with a better creditworthiness. But this would result in a different unit of account because the pension promise itself would be altered, and should, therefore, not be included in the measurement of the existing obligation.

e) We agree that expenses of administering the plan's accrued benefits should be reflected in the liability because the liability cannot be settled without incurring such expenses.

Question 7
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 GASB takes the view that the liability should be reported at an amount that reflects the probability of different outcomes measured on a portfolio basis because this best mirrors the economic reality. Assuming that beneficiaries always choose the highest amount would ignore personal preferences of the employees (e.g. short-term liquidity need) and would therefore overestimate the economic burden of the entity caused by the pension obligation.

Only in those cases where there is insufficient information about the probability of different outcomes – which might be the case for a new kind of pension plan for which there is no experience how many employees prefer available options – the highest amount should be reported instead, since in such an instance the entity has to presume prima facie that the beneficiaries choose the most burdensome outcome for the entity.

Chapter 6: Measurement of assets held to pay benefits

Question 8
Do you agree that assets held to pay benefits should be reported at current values?

We do not agree with the Discussion Paper in shifting the view from “plan assets” as defined by IAS 19 to “assets held to pay benefits”. We continue to support that plan assets should be reported at current value, rather than at historical costs. In contrast to the Discussion paper and in accordance with IAS 19, we also favour a net presentation approach (i.e. the entity recognises its entire obligation as a liability after deducting the fair value of the assets held by the fund (see also response to Question 4). Therefore, in our view it is essential that the assets held to pay benefits are limited to assets which exist solely to pay or fund employee benefits and are not available to the reporting entity’s own creditors (even in bankruptcy) and which are legally separated from the reporting entity.

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

Question 9
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?

The GASB supports the view 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 share the conclusion of the analysis (see DP, Chapter 7, paragraph 4.10) that the employer has similar economic exposures whether the liability and/or the assets are held by the employer or a trust if the employer has to make good any shortfall of the trust. Therefore, it is consistent to measure the asset and the liabilities held by a trust as if they were measured directly.

Chapter 8: Presentation in the financial statements

Question 10
Do you agree that different components of changes in liabilities and/or assets should be presented separately?

We believe that presentation in the financial statements is an issue that should not be solved on a standard by standard basis, but rather be driven by a principle-based presentation approach that provides users with useful information (i.e. the users of the financial statements shall be able to analyse which economic reasons trigger the change in a liability or an asset).

Regarding the presentation of pensions we, therefore, agree that different components of changes in liabilities and/or assets should be presented separately. The GASB holds the view that:

- Service cost should be reported within operating activities in profit or loss.
- The unwinding of the liability for pensions should be presented within financing costs in profit or loss.
- Actuarial gains and losses should be reported in other comprehensive income (OCI) as far as changes of the liability or the plan assets are concerned, which are generally reversible over time. Therefore, effects stemming from changes in the interest rate should be presented as part of OCI.

Based on these considerations, the GASB prefers the approach discussed in den IASB Discussion Paper *Preliminary Views on Amendments to IAS 19 Employee Benefits* which presents remeasurements that arise from changes in financial assumptions in other comprehensive income. Remeasurements arising from changes in financial assumptions are prompted by changes in the discount rate and the value of plan assets. In contrast, changes in the amount of post-employment benefit costs other than those arising from changes in financial assumptions, e.g. the costs of service, interest cost (i.e. the unwinding) and interest income, should be presented in profit or loss.

A minority of GASB members takes the view that all changes in the defined benefit obligation and in the value of plan assets should be presented in profit or loss. They argue that there is no conceptual basis for recognising items outside of profit or loss. They draw a comparison with IAS 37 which requires entities to recognise changes in liabilities, including changes in long-term liabilities, in profit or loss in the period they occur.

Question 11
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 the subjectivity inherent in determining the expected rate of return may include the risk to choose a rate with a biased view to trigger a desired impact on profit or loss. However, this risk is inherent to any estimate made for accounting purposes and, in our view, is to be covered by the reporting entity's internal controls, the auditors and the enforcers and not by accounting standards. Reflecting the expected return is more appropriate for our preferred accounting model for defined benefit plans, i.e. final salary plans, as outlined in our above comments. Therefore, as already outlined in our comment on Question 10, 3rd bullet, actuarial gains or losses on plan assets should be recognised in OCI (and expected return in profit or loss), rather than following the proposed treatment in the Discussion Paper.

A minority of GASB members is of the opinion that entities should not divide the return on assets into an expected return and an actuarial gain or loss. Because of conceptual reasons they prefer recognising the actual return in profit or loss.

Chapter 9: Disclosures in the employer's financial statements

Question 12
Do you agree with the objectives of disclosure that are identified in this Chapter? Are there specific disclosure requirements that should be added to or deleted from those proposed?

We agree with the high level disclosure objectives set out in the paper. Particularly, we share the view that the role of investment strategy in meeting obligations to pay benefits requires an explanation in the notes because users are interested in the employer's ability to continue to meet its obligations as they fall due.

When reviewing the appropriateness of disclosures it is noteworthy that over the years many entities have established a variety of plans to be considered at the reporting date. This particularly applies to companies with operations in different countries. Disclosures on a plan-by plan-basis are unlikely to provide useful information. Therefore, an appropriate aggregated presentation of such plans is essential taking into account, for example, their significance, similar characteristics, and assumptions, if any. The disclosure requirements should provide guidance for such aggregation.

Chapter 10: Accounting for multi-employer plans

Question 13
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?

The GASB generally prefers applying consistent principles regardless of whether single or multi-employer plans are to be reflected in an employer's financial statements. Nevertheless, it has to be considered that in practice very different situations exist. The specifics of the individual case should be taken into account.

Chapter 11: Financial reporting by pension plans

Question 14
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 believe that the main purpose of the pension plan's financial statements is to demonstrate stewardship by the plan's fiduciaries. This purpose is not congruent with providing information to the stakeholders of an entity to facilitate their decision making. But this does not mean that the information given to members of a plan and those who act in their interests has to be different from the information given to stakeholders of an entity. In our opinion, both users need the same useful information. This information can either be used for decision-making purposes or supervising the plan's fiduciaries. Thus, the GASB sees no convincing reason why liabilities should not be included in the pension plan's general purpose financial statements or financial report respectively.

Furthermore, the GASB believes that there is no persuasive argument why plan's liabilities for future benefits should be quantified using different principles than in the financial statements of an employer. With regard to comparability in particular, it makes no sense to account for liabilities for future benefits in a different way only because the liabilities have been transferred from the entity to a pension plan.

Question 15
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?

Based on the rationale that the same accounting principles should apply to the financial statements of a pension plan and to the financial statements of any other entity, we believe that an (contingent) asset should be recognised if the requirements of IFRSs (i.e. IAS 37) are met. The same rationale is applicable for credit risk on any receivables, irrespective of whether the debtor is the employer or any third party. It is a generally accepted accounting principle that an assessment of the recoverable amount should be made and the asset should be written down if there is a significant risk that the counterpart will not be able to fulfil its obligation. The same should apply for a pension plan's (contingent) asset in respect of an employer's covenant.

General questions

Question 16
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.

Our statements in this comment letter primarily focus on accounting principles with regard to typical defined benefit plans like final salary plans. In our opinion, pension arrangements like cash balance plans require further consideration. We are not sure that the existing accounting problems of these plans can be solved adequately by applying the principles of this paper. Detailed comments to this kind of troublesome plans will be given in the comment letter to the IASB DP *Preliminary Views on Amendments to IAS 19 Employee Benefits*.

Question 17

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

No comments.