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14th July 2008

Accounting Standards Board
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Dear Sir or Madam

PAAinE Discussion Paper The Financial Reporting of Pensions

We welcome the Discussion Paper as a useful step forward in the pension accounting debate and are pleased to respond below with our views.

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)? [Page 27, paragraph 2.16, page 34 paragraph 4.2, and main Chapter 2 discussion in paragraphs 4.31 (page 39) to 4.56.]*

IFRS (for example IAS 36.40 impairment testing) requires consistency between estimates of future cash flows and how they are discounted, i.e. either a money-of-the-day (nominal) or real-terms rate should be used, depending on whether the estimates respectively include or exclude inflation.

We view salary increases (rather than, for example, a general consumer index) as best representing the impact of inflation on pension liabilities and would similarly apply the above approach. When discounting liabilities at market (i.e. MOD) interest rates, it would be inconsistent and misleading not to include salary inflation in liability measurement.

We believe that the key driver for incurring and recognizing defined benefit obligations is the rendering of service and that salary increases should be seen only as a measurement attribute, rather than – and unlike future changes to plan terms and conditions – relating to benefits to which the entity is not yet committed. We note the arguments (in Chapter 2 paragraph 4.49) that increases in other remuneration – such as salaries and bonuses – are accounted for only in the periods in which they occur – but would point out that these differ from pension obligations in that the service to which they relate has not yet been rendered.

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Furthermore, the employer operating in a normal, competitive business environment cannot avoid increasing the future salaries of his workforce (with consequent impact upon pension benefits) if he wishes to retain their services. Whilst this may be "economic compulsion" rather than an IAS 37 constructive obligation, we do not believe that the usefulness of financial statements is improved by ignoring it.

We note the increasing cost trend (before discounting) shown in Example 10 (page 53, and Table 1 on page 41) as resulting from the "liability based on current salary" approach and believe that there would need to be both strong conceptual and practical grounds before expense was deferred in this way.

In practical terms we believe that the liability measure most useful to financial statement users is one that reflects the amount that would need to be set aside now for future settlement of pension liabilities based on service to date, allowing for all future salary increases (consequently we would also include discretionary salary increases in the liability measurement). Inclusion of future salary increases continues to provide (in the words of IAS 19.36) the most relevant measure of the estimated outflow of resources.

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? [Chapter 2 section 5, page 49]*

The actuarial valuation of pension liabilities reflects statistical assumptions such as mortality that are valid only for large populations rather than individual employees. Sufficiency of plan assets is also judged by measurement against liabilities on a total plan basis. We believe that the liability should, consistently, be calculated on the basis of the workforce as a whole.

We note the "unit of account" discussion in Chapter 2 paragraphs 5.4 to 5.7, including the view that a different liability might be recognised if obligations are first considered on an individual employee basis, rather than taking the workforce as a whole. We do not agree that (paragraph 5.7) the obligation to the whole workforce could be derived from "the sum of the obligations to individuals". We suggest that a simple summation is unrealistic both conceptually and economically, ignoring as it does the effect of increasing scale on the options available to the employer.

Q3 *Do you agree that recognition should be based on the principle of reflecting only present obligations as liabilities? [Chapter 2 section 6, pages 51 to 63]*

We agree with the principle that only present obligations should be recognised as liabilities, whilst recognising that issues may then arise as to what a "present obligation" comprises and how it is measured (including the treatment of future salary increases, discussed above).

We agree with the Discussion Paper's statement (page 52 paragraph 6.7(b)) that the principle behind the requirement to override the plan benefit formula and instead attribute benefit on a straight-line basis when employee service in later years leads to a materially higher benefit than in earlier years, is not explained in IAS 19 (in which paragraphs BC 23/25 refer). Whilst this requirement might be seen as simply another smoothing mechanism, we suggest that any proposal to remove (or reduce the scope of) it should also consider the practical risk of plans being structured in order to provide a preferred pattern of pension expense.

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? [Chapter 3 section 3, pages 79 to 92]*

We believe that many plans would not meet consolidation requirements, being specifically structured to ensure that - as a safeguard for plan members - sponsoring companies do not have control and that member interests take precedence.

We agree that the normal principles of consolidation – and in particular the notion of control - should be applied in determining whether a pension plan should be consolidated (with consequent gross presentation of plan assets and liabilities). We agree also that such application must however fully recognise the nature of the trust deed, the impact of the regulatory framework, and any resulting constraints upon the actions of trustees.

Where companies can benefit from a net surplus or must fund a net liability, but have no rights or obligations concerning the underlying gross positions, it would be misleading to present gross amounts in the company balance sheet. In such cases we agree with the DP conclusion (paragraph 2.41) that presentation of a net asset or liability is more appropriate.

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? [Chapter 4]*

We understand why the plan surplus or deficit is considered the amount most usefully reported to accounts users as an asset or liability respectively, rather than values reflecting smoothing or deferral of gains and losses.

We would note that this does not necessarily require that the impact of changes in plan assets and liabilities be also recognised immediately in the income statement: for example, gains and losses could instead be deferred within equity (our response to Question 11 also refers).

Although not an accounting issue, we also suggest that the impact on distributable profits should be fully understood before any implementation of immediate recognition.

Q6 *Do you agree with the paper's views in the measurement of liabilities to pay benefits?…..*

The paper concludes (in Chapter 5, paragraph 5.14) that, if alternative means of settling a liability are currently available to an entity (i.e. it is within the employer's control to achieve them), the liability should be reported at the lowest amount of the available alternatives.

We believe that liabilities should be reflected based on management's assessment of the expected outcome. As a consequence we support the conclusion only provided that management indeed intends to follow the "lowest liability" route.

In particular, do you agree that:
- Regulatory measures should not replace measures derived from general accounting principles? [Chapter 5 paragraph 6.7, pages 113 to 116]

We agree that pension plan assets and liabilities should be consistently measured in accordance with general accounting principles, rather than by applying the various methods used for funding sufficiency tests or other regulatory compliance purposes.

However any impact of regulation on assets and liabilities (for example the effect of minimum funding requirements) should of course be reflected in such measurement.

- The discount rate should reflect the time value of money only, and therefore should be a risk free rate? [Chapter 5 paragraph 6.37 (pages 120 to 121) and 6.53.]

We agree that discounting should reflect the time value of money, a liability payable in the future being less onerous than one that is payable now. How much less onerous depends upon how the assets that will be used to settle the liability are invested during the intervening period and this should in principle affect the choice of discount rate.

Whilst section 6.53 notes that, in theory, the liability should reflect a margin for risk, we suggest that it should also reflect a margin for reward in cases where ring-fenced assets and their associated returns are available to fund it. We do not believe that the use of a risk-free rate in such cases meets the IASB Framework objective of helping users to assess the amounts of expected future cash outflows.

In practical terms, we believe that using the rate of return applicable to government bonds would provide investors with an overstated, unrealistic view of plan liabilities, given the availability of a corporate bond market where related plan assets could be invested to provide a higher (but still low risk) return. It would also increase the gap between published values and the bases on which future funding requirements are likely to be determined. [We would also point out that there is no such thing as a genuinely risk-free investment: government bonds, for example are low-risk rather than no-risk.]

We suggest that plan liabilities are most usefully discounted in a way that reflects the resources that would have to be set aside now in order to meet such obligations on a reasonable, low risk basis, i.e. based on investments yielding the maximum return for which future cash flow estimation does not require the caveat, "past results are not necessarily a guide to future performance."

We would expect a portfolio of high quality corporate bonds - and the related investment return - to be an acceptable, prudent source of such funding and suggest that their (externally verifiable) rate of return is therefore an appropriate choice of discount rate. However we are concerned that applying the present limited IAS 19 guidance may result in diverse outcomes and suggest that the requirements be reviewed, with the aim of ensuring that entities with similar pension liability phasing arrive at a similar choice of discount rate.

Funded plan liabilities will in reality be settled using capital and earnings from a diversified portfolio comprising many different asset types. Whilst an argument could be made for discounting plan liabilities at the rate of return expected from this portfolio, we believe that this would be too subjective and uncertain and would hinder comparability between different entities.

- 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? [Chapter 5 paragraph 6.42, pages 122 to 124]

We agree that risks arising from uncertainty in pension assumptions (for example concerning life expectancy) are best reflected through disclosure of sensitivities rather than adjusting the reported liabilities.

- The liability should not be reduced to reflect its [i.e. the entity's] credit risk? [Chapter 5 section 7, pages 124 to 130]

We agree that it would be counterintuitive for a company with a poor credit rating to report lower pension liabilities than a well-rated company with similar obligations and note that similar issues arise under the IAS 39 fair valuation of debt. We believe that such an approach would focus on the wrong cash flows: credit risk affects the rate at which a company can borrow money, rather than either the rate at which the resulting funds could be invested to meet plan liabilities or the rate inherent in the amount that plan trustees or members would accept now in order to relieve the company of its obligations.

- Expenses of administering the plan's accrued benefits should be reflected in the liability? [Chapter 5 section 8, pages 130 to 133]

We believe that future plan administration costs should be expensed in future periods when incurred, rather than being immediately reflected in the liability.

This approach seems consistent with the IAS 39.47 treatment of future transaction costs relating to financial liabilities measured after initial recognition using the effective interest method. Such costs are included in the estimation of future cash flows used to calculate the effective interest rate (IAS 39.9) and are thereby expensed over the liability's lifetime rather than being recognised immediately.

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? [Chapter 5 section 5, pages 111 to 112]*

We believe that the amount reported should aim to realistically reflect expected future cash flows rather than a worst-case scenario and that the appropriate calculation method will vary depending on individual entity circumstances.

An expected value approach could be appropriate where there is a large employee population and sufficient evidence to reliably estimate the probabilities of various options being selected.

Q8 *Do you agree that assets held to pay benefits should be reported at current values? [Chapter 6, page 149]*

We agree that current values are the most appropriate measure and that the guidance available in other accounting standards should be applied when determining these.

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?* [Chapter 7, pages 163 to 167]

We agree that a 'net' plan 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 do not support the alternative discussed, of measurement based on discounting future cash flows expected to be contributed from the employer to the trust. We share the concern that this would introduce greater subjectivity – and may understate the balance sheet liability - through inherent incorporation of forecast future returns on plan assets. It would also create a discontinuity between the balance sheet and disclosures of underlying plan assets and liabilities.

Q10 *Do you agree that different components of changes in liabilities and/or assets should be presented separately? [Chapter 8 section 3, pages 171 to 173]*

The presentation in the financial performance statement of a single, net amount for pension expense is in our view consistent with presenting a net position in the balance sheet. It seems misleading to separately report items that – from the employer viewpoint – may be managed and settled on a net basis as a component of employee compensation. We suggest that, as at present, any predictive needs of account users for further detail could instead be met by disclosure in notes to the financial statements.

This response is however made in the context of the present IAS 19 accounting requirements. If, for example, smoothing were to be removed from the income statement, it would be essential to report immediately-recognised actuarial gains/losses and actual returns on plan assets outside net income, which could otherwise be completely distorted.

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? [Chapter 8 section 5, pages 175 to 176]*

We accept immediate recognition in the balance sheet, but do not believe that immediate recognition of gains or losses in the income statement provides useful information, since this frequently does not reflect the real periodic impact on an entity's resources. Plan deficits are often not funded immediately but may instead be eliminated over a number of years, while the benefits of a plan surplus are likely to be realised only gradually, through reduced contributions.

Similarly the use of the long-term expected return in calculating the amount for the income statement reflects better the impact on an entity's cash resources, in that actual losses do not necessarily require urgent cash funding and the entity may not immediately benefit from gains. Therefore the amount to be reported in income should be consistent with the existing approach, and all other components reported in Other Comprehensive Income (with some form of recycling through net income).

We note also that smoothing was introduced mainly for practical reasons, pending resolution of the performance reporting issues that arise from immediate recognition. If the income statement were instead to immediately reflect the impact of changes in plan assets and liabilities, it would first be essential to develop an appropriate presentation of the unsmoothed components in the performance statement. In particular, these components should be clearly distinguishable from an entity's operating results to ensure that these are not "swamped" by pension volatility.

Q12 *Do you agree with the objectives of disclosure that are identified in this Chapter? [Chapter 9 section 2.13, page 188)] Are there specific disclosure requirements that should be added to or deleted from those proposed? [Chapter 9 Appendix A, page 204]*

We agree with the objectives as identified in this chapter and welcome the emphasis that disclosure is only necessary where relevant and material.

Whilst we also agree that all the proposed new disclosures have their merits, they would represent a significant addition to the current IAS 19 requirements. We therefore suggest that their cost/benefits would require prioritisation, for example by ascertaining which new items are seen as most important by accounts users.

Concerning the proposed segregation of plans into those in surplus and those in deficit, we believe that this would only be useful if the aggregated disclosures were in some way misleading to accounts users, for example if the expected timing of economic benefit realisation from surpluses differed significantly from the timing of deficit funding, and with consequent very material impact on entity liquidity.

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?*

We agree that the same principles should be applied, whilst allowing for any practical difficulties in obtaining information and also recognising the differing employer and employee legal rights and obligations that may exist in this category.

Concerning implementation we would not change the existing IAS 19 requirement for an entity to account for its proportionate share of the defined benefit obligation, plan assets and cost, provided that sufficient information is available. We agree that successful application depends on proper judgement being exercised in selecting an allocation key.

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?*

No comments.

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 comments.

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.*

No comments.

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?*

No comments.

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Yours sincerely.

Bob Deere

Vice President Accounting and Reporting