PAAINE DISCUSSION PAPER - *THE FINANCIAL REPORTING OF PENSIONS*

**Comment letter**

Dear Sir/ Madam,

The IAS 19 working group of the Académie des Sciences et Techniques Comptables et Financières would like to bring to your attention the comments recapitulated below on the Discussion paper on the financial reporting of pensions.

A presentation of the Académie des Sciences et Techniques Comptables et Financières and its IAS 19 working group is provided for your reference in the Appendix.

The comments below have been prepared based on majority consensus within working group members, and selected for their relevance, but might not reflect the views of each individual working group member, and do not engage nor constitute any expression of their respective organisations.

If you would like further clarification of the issues raised in this document, please do not hesitate to contact Selma Naciri or me.

Yours Sincerely

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IAS 19 working group, Chairman

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***Scope***

We have noted the choice of the discussion paper to focus on obligations to provide pensions and not to address obligations to provide other types of benefits. Nevertheless, we think that other long term benefits and other types of post- employment benefits such as the provision of medical care during retirement should be given more attention since they may raise specific questions / issues or may be significant in practice. For example:

- More and more plans provide the possibility for the beneficiaries to receive payment before leaving service. These plans have the features of pos-employment benefits and other long term benefits. It is sometimes difficult to differentiate between the two categories because the may both be paid before leaving service.
- Medical care obligations disclosed by CAC 40 groups in 2006 amounts to 13 billon euros which is approximately 7% of the DBO of the CAC 40 groups. Even if medical care figures are not given systematically by CAC 40 groups, the aggregation of available figures illustrates the fact that such benefit are of importance.

Therefore, we suggest that the PAAinE working group scope in other long term benefits and other post-employment benefits. If the discussion paper was to confirm that post-employment benefits and other long term benefits are conceptually similar, it should explain the underlying analysis. It may also be useful that the discussion paper confirms that medical care benefits are dealt with as pension benefits.

***Q 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)?***

Liabilities to pay benefits should be based on salaries when employees are expected to leave. Indeed, an employer who currently promises a pension equal to 2% of final salary should recognize a higher cost than an employer who promises a pension equal to 2% of current salary (to reflect the difference in promise).

The discussion paper view is that some salaries increases should be taken into account for the measurement of pension liability and other salaries increases should no be taken into account. The bright line between the two categories is based on the existence of a contractual guarantee to grant salary increases.

We do not support this analysis as we do not find any reason to depart from a measurement based on the "best estimate" principle which reflects the underlying obligations.

Salary increases is only one assumption among others for the liability measurement. Therefore, is it coherent to take into account expected changes in mortality rates and indexation factors and not expected changes in salaries?

We have the view that if the assumption on salary increases retains only contractual guaranteed increases for the employee benefit measurement that may be inconsistent with other liabilities measurement such as decommissioning liabilities which are also "long term" liabilities.

As it is stated in §4.49, chapter 2, “some believe that the current approach is inconsistent with the treatment of expected increases in other elements of remuneration – such as salaries and bonuses- which are accounted for in the periods in which they occur. They believe that the increase in value of an employee’s pension benefits is in economic terms not distinguishable from the rest of the remuneration for each year of service – in effect it is a bonus in the form of additional pension benefits.”

We think that reflecting future salary increases can not be directly linked to the treatment of expected increases in other elements of remuneration such as salaries and bonuses (as it is stated in § 4.49). The nature of the promise is different in the case of salaries and in the cases of deferred benefits:

- Case 1: salaries and bonuses paid correspond to the employer promise to pay a contractual salary plus any discretionary bonus.
- Case 2: Deferred benefits correspond to the employer promise to pay a benefit corresponding to <u>a promise that is related to a future salary</u> (the employer is committed to pay a benefit which takes the form of a current salary plus future increases).

In practice, employees’ contracts rarely include compulsory increases clauses and therefore, under the discussion paper’s proposals, present obligation would exclude future increases.

Not including future salary increases in the measurement of pension liability would lead to the deferral of the recognition of pension cost relating to past service.

***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 recognition and measurement of pensions obligations?***

Financial reporting should be based on the premise that a liability is owed to an individual employee rather than to the workforce as a whole simply because benefits are usually based on a contractual obligation with individual employees. Nevertheless, the notion of a workforce as a whole may be used for measurement purpose as the law of large numbers permits a more relevant calculation.
For assumption setting, workforce as a whole should be considered.

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

We agree with the approach based on present obligations. However the discussion paper is not convincing when differentiating between constructive obligations (included in the liability) and discretionary obligations (excluded from the liability).

The Discussion paper refers to discretionary benefits as something that can not correspond to a constructive obligation. (See §4.14). We think that discretionary benefits can in fact arise from constructive obligation.

Regarding future salary increases, it can not be assumed for example that an employer will never increase salaries in the future. On the contrary, it is generally assumed that general increases in salaries are granted to offset negative inflation impact or that promotions are granted to reward past services. It is also generally agreed that an entity creates a valid expectation among employees that it will increase benefits to a certain extent even if giving such additional benefits is a discretionary decision that the entity is not obliged to take.

As the border line between constructive obligation and a discretionary obligation, in the context of future salary increases, is narrow, and difference between constructive obligation and discretionary salary increases may result in judgement and different practices (reducing comparability between various companies, countries, etc.), we suggest that the discussion paper go further in the analysis of the following questions:

- How a constructive obligation may be defined in the context of employee benefits?
- How far past practices give rise to a constructive obligation?

***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?***

Yes, since there is no conceptual reason why existing financial reporting standards provide an exemption from the consolidation of pension plans. Nevertheless, we believe that pension plans raise specific issues:

- Pensions funds are mainly aimed to securing assets to pay benefits and the employer usually bear major risks regarding the benefits to be paid. In a going concern perspective it may be difficult for the employer to refuse to assume the liability arising from promises made to pensioners or active employees. This would support the consolidation of the fund.
- On the other hand, some funds have the power of increasing employees' contributions and/ or decreasing payments to be made to pensioners or buy out employee benefits at a transfer value, which would support the non consolidation of the fund.
- Power is often shared between the employers, employee representative, and/ort trustees which make a case by case analysis of the balance of powers necessary before deciding on consolidation

We do not agree with the all of the views expressed in Chapter 3. In particular;

- The proposed criteria for control do not include the responsibility for absorbing residual plan deficits.
- The criterion according to which "the activity of the fund is conducted on behalf of the entity according to its specific business needs so that the entity obtains benefits" is not investigated. The fact that a fund is managed by a trust (ex: UK trusts) does not preclude that the entity obtains benefits from the pension plan and is exposed to any deficit of the plan.
- It is not clear why control can not be identified in cases where the trustees have the power to share surpluses and deficits between employers and employees. At least there may be a kind of joint control.

We think also that it may be useful to follow up IASB consolidation project and to assess whether the new criteria envisaged are relevant for pension plans.

***Q5 – Do you agree that the 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 that they are within certain limits (a corridor) approach ?***

In our view, there are some valid arguments for preferring immediate to deferred recognition:

- Immediate recognition permits transparent information since the balance sheet faithfully reflects the entity's liability.

- Deferral mechanisms induce a complexity for preparers of financial statement and above all for users because the information in the notes of financial statements is quite difficult to follow up.

Nevertheless the proposed change regarding present requirement raises several questions:

- The relevance for users of recognising short term fluctuations is not evident. Valuation variations to be all recognized in P&L seems inappropriate as this would create a lot of (meaningless) volatility in the P&L of companies with significant pension exposure, and accounting arbitrage risks. It may be also meaningless since the liability is not measured at fair value,
- To which view of performance does this relate? We think that the question of presentation of financial performance should be addressed first and more thoroughly before removing deferred recognition. More precisely we think that the “volatility” issue is to be addressed when considering the financial statement presentation project.

***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?***

We agree. Regulatory measures include some additional requirements of prudence, have different objectives and they vary significantly country by country.

Nevertheless, regulatory requirements may affect assets, liabilities and cash outflows. For example when funding is not sufficient, employers and employees are compelled to negotiate in order to reach a balanced situation. Such a situation may lead to a decrease of the liability. On the contrary, when the plan is funded, the employee’s obligation to pay benefit is more certain. Such an impact of regulatory requirement should be taken in the measurement of assets and liabilities to pay benefits (cf. IFRIC 14 i.e. minimum funding requirements which result in additional liabilities beyond the payment of future benefits foreseen by the pension plan).

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

Alternative views have been expressed on this issue and no real consensus could be reached.

*Discount rate based on contribution determination*

For funded pension plans, which build up the majority of employers’ liabilities in practice, employers’ pension costs are made of contributions to be paid to an external funding vehicle, which represent the true economic impact of running pension plans. Usually, contributions are determined based on a set of actuarial assumptions including a discount rate assumption.

Technical basis for the determination of the discount rate usually rely on the judgement of the scheme’s actuary, within certain boundaries prescribed by solvency constraints. Therefore, there is probably no better economic determination of the discount factor than to rely on the characteristics of each particular scheme and legislation, and the judgement of the funding actuary, as these elements determine the economic cash outflows resulting from the existence of the pension plan. The discount rate could therefore be based on the discount factor used by the scheme actuary in the determination of employer contributions. For unfunded plans, a more standard discount rate would need to be elected and could be based on the level of subordination of the pension debt compared to other financial debts.

*Discount rate based on the expected rate of asset return*

Traditional actuarial methods usually foresee discounting of future benefit payments based on the expected rate of return on any plan assets to determine the funded status for funding purposes. For pension plans whereby plan assets are partially invested in equities, one could argue that the application of a risk-free discount rate overstates the liability (hence, an artificial deficit is shown in the financial statements).

*Discount rate based on swap curve*

Depending on the outcome of the discussion around “current value” measurement, another reference which could be considered for selecting discount rates could be the swap curve (i.e. the interbanking yields on fixed/floating swaps) essentially for liquidity considerations. In most countries, swaps markets are very liquid even for long durations which is not always the case for bonds. Any discount rate referred to swap curve would provide very transparent, consistent and liquid measurement basis, and also represent an economic reference as most pension funds have entered into liability driven investment strategies where interest rates hedges mostly rely on swap mechanisms. Swap rates are also used by most buy out firms which can be considered as a secondary market for pension debt, and thus a basis for a market-based, or fair value, measurement of pension liabilities.

*Current practice*

Current practice of applying an AA corporate bond yield seems a reasonable approximation / compromise which ensure comparability and a reasonably neutral measurement of the liabilities.

*Disclosures*

To resolve this issue, the duration of the liabilities could be disclosed to provide useful information on impact of the discount rate (cf. current disclosure requirements regarding sensitivity analysis for measurement of post-retirement medical benefits which tend to be less important outside the US)

***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 adjusting the amount of the reported liability?***

We agree that the riskiness is to be conveyed by disclosure. Nevertheless, we think that information about the riskiness of a liability (or, more relevant, the funded status as the interaction with the riskiness of plan assets should also be taken into account) may be difficult to provide in an understandable way.

One can give “easily” some information through a sensitivity analysis but more relevant information about the risk itself would imply probably that the company provides relevant disclosures on the range of probable values (i.e. Defined benefit obligation or, more interesting, the unfunded defined benefit obligation should be with 90% probability in the range 9 million euros to 11 million euros). This would imply complex calculations and some more assumptions than the ones currently used (currently done through ALM studies).

Therefore, we wonder if it is a realistic objective to provide disclosure on the riskiness of the liabilities or funded status.

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

We agree that the liability should not be reduced to reflect its credit risk. Including a credit risk based on the credit risk of the liability:

- would be a significant change to using AA corporate bonds ;
- might lead to distortions in financial information and accounting arbitrage ;
- lead to a liability that is less important when the credit risk is higher ;
- would not be consistent with measurement requirements under IAS 39.

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

Expenses of administrating the plan are part of the liability to pay benefits and therefore should be reflected in the liability, but it is not sure that the implementation of such principle is desirable since it may be difficult to identify the relevant expense. For example, should investment expenses be deducted from the return on plan assets or included in the liability?

***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?***

Two views are expressed by the discussion paper: report the higher value until the employee elects to receive the lower value; or measure the liability on a best estimate or expected value reflecting the probability of different outcomes. In our view, reporting the higher value until the employee elects to receive the lower view does not reflect faithfully the liability to pay benefits. As answered to question 1, we are in favour of 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?***

Measurement principle for assets held to pay benefits shall be consistent with measurement principles for corresponding liabilities. Therefore assets should be measured at current values since the corresponding liabilities are measured at current value too.

We would like to point out that:

- "Transfer price" could be a good reference in the context of pension but not for active employees since employer may rarely be able to transfer their entire obligation. For example, insurance companies usually do not accept to cover future salary increases.
- The current value of insurance contracts covering pension liabilities – which is a very common way of funding pensions on the continent - would need to be further defined.
- Are future employees' contributions to be considered as an asset of the plan?

***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 that if the contractual arrangement results in a 'net' asset or liability being representative of the employer's rights and obligations, the measurement of the net amount should be based on the difference between the amounts at which the assets and liabilities would be measured if they were measured directly i.e. if the assets and liabilities were directly held by the employer.

However, if the holding of the liabilities by an external fund impact the cost of the liability (solvency ratio to fulfil, administrative costs, etc…), this should be taken into account in the valuation of the liability

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

We agree that pension net cost should be differentiated between an operating cost and a financial item.

However, Interest cost and expected return on plan assets are financing items and are clearly identifiable; but actuarial gains/losses are more difficult to split as assumptions are usually related (cf. discount rate, salary increases, social security increases, pension indexation may all likely to be related to inflation).

***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?***

Reflecting actual return on assets rather than expected return is coherent with the discussion paper's proposal to remove deferred recognition. Our view is that:

- actual return on assets would introduce volatility into the reported income and earnings per share;
- Reflecting actual return on assets is not coherent with the fact that assets are held with a view of securing a long term liability.

We acknowledge that using an expected return rate may be biased but we think that such an issue may be addressed by specific disclosures.

***Q12. Do you agree with the objectives of disclosure that are identified in this chapter? Is there specific disclosure requirements that should be added to or deleted from those proposed?***

Change proposed would mainly bring better information on pension liabilities and assets risks and measurement, and a better dynamic view on the cash outflows and on the way the pension liabilities will be met in the future. Our further remarks are the following:

- We think that a liability breakdown between vested and unvested benefits may give useful information since the corresponding liability has not the same degree of certainty.
- Disclosing an alternative measure of pension liabilities is confusing and usefulness.
- The discussion paper proposal should be reassessed regarding the objective of a sustainable costs/ benefits ratio.

***Q13 – Do you agree that a 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?***

In our view, rights and obligations of an entity may be different depending on the nature of the plan: a single employer plan and multi-employer plan. In the multi-employer plan context, rights and obligations are shared between several entities and the obligation of an entity may rather be a sort of pay as you go obligation, since for example, after a major restructuring the entity would pay for a smaller population (its contribution basis would drop) and all other participating companies would have to cover any deficit in respect of the former employees of that entity.
Besides, measurement of assets and liabilities may be more challenging in this context.

***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 futures benefits should be quantified using the same principles as an employer's liability?***

No comment.

***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 be reflect the employer's credit risk ?***

No comment.

***Q16 – Are there types of pension arrangements that requires further consideration? Please identity the specific features of these arrangements and suggest how the principles of this paper require development to secure appropriate financial reporting for them.***

The preface of the discussion paper states that the paper differs from existing standard since it advocates that the same principles should be applied to all pension arrangements, whether defined contribution or defined benefits plans. We have not find in the DP clear explanation about the possibility of applying the same principles to different arrangements. In particular, it is not clear how specific issues raised by "cash balance plans" may be dealt with under the DP proposals. Therefore, more explicit reference to pension plans with guaranteed investment return (cf. IASB discussion paper and reference to those plans in Chapter 5 - 6.32) could be made. These plans which are of importance raises specific issues as traditional actuarial methods do not work for their measurement and as a fair value approach may make sense.

Besides, the DP focuses on the existence of trusts as they may exist in UK. It may be useful to identify the different major kinds of arrangement existing for example throughout Europe in order to assess the applicability of DP proposals' in these contexts.

As stated in the introduction of this comment letter, we think that the scope of the discussion paper should be expanded.

***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?***

Even if we agree on the discussion paper proposals according to disclosures, we think that further analysis should be conducted to make sure that the cost/ benefit ratio is sustainable.

# Appendix

## L’Académie des Sciences et Techniques Comptables et Financières

The French Academy of Accounting and Financial Sciences and Techniques was formed in 2004 as an initiative of the Ordre des Experts Comptables (professional accountancy body for Chartered Accountants) with 3 objectives:

- to gather professionals involved in audit, financial control and finance on the basis of shared values, and enable them to exchange their views on common issues and define best practices
- to improve the level of theoretical and practical research about these issues and produce / publish the outcome of such works
- to create a multi-disciplinary network of professionals serving the economy and forming a basis for exporting French values and savoir faire abroad

The Academy is now a network of almost 35 000 professionals in more than 20 countries, with the support of all institutional actors in France’s economic and financial markets.

## IAS 19 working group

L’Académie has formed an IAS 19 / Employee Benefits working group in 2005 to follow up the development of accounting standards in the area of pension and employee benefits, and participate in research initiatives.

Working group members are representatives of:

- the accounting, financial, audit and actuarial professions in Belgium, France, and Switzerland
- multinational companies including 5 CAC 40 groups
- the academic world
- the national standard setter
- 6 different nationalities.

The working group has initially focused on the “long term” pension revision project conducted by ASB for the PAAinE. In cooperation with the French national standard setter – le Conseil National e la Comptabilité- the IAS 19 working group of l’Académie has analysed draft papers of ASB panel and EFRAG pensions working group.

The working group has also contributed to the Comment Letter of the Conseil National de la Comptabilité on IFRIC draft interpretation D19 – assets ceiling: availability of economic benefits and minimum funding requirements.

At last, the working group has focused recently on the “short term” IAS 19 revision project conducted by the IASB, based first on public information available and afterwards on the IASB discussion paper.

## Contacts

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