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DISCUSSION PAPER: THE FINANCIAL REPORTING OF PENSIONS

Dear Sir / Madam,

SwissHoldings represents 46 Swiss groups, including most of the country's major industrial and commercial firms. We very much welcome the opportunity to comment on the above DP, and our response below has been prepared in conjunction with our member companies. We agree that the financial reporting of pensions should be reviewed.

Specific comments

Chapter 2, Liabilities to pay benefits

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 do not believe that this is primarily a question of recognition but one of measurement. The "slice" of ultimate pension attributable in the former case is not a separate liability but flows into financial reporting via the measurement of the liability to pay the (whole) pension in terms of expected cash flows. Consequently we believe that expected pensionable salaries must be included as part of the best estimate of the amount required to settle the liability. Inclusion of expected pensionable salaries gives more meaningful and useful information to users and preparers alike. Using salary levels at the reporting date without any inflation would be inconsistent with other assumptions such as the discount rate, which is a nominal rather than a real rate according to both IAS 19 and the DP proposals, and as far as we are aware, supporters of modifying the IAS 19 measurement requirement so as to exclude future expectations of pensionable pay increases would accept forward projection of general price inflation and would exclude only the excess of earnings growth over price inflation from the liability measurement.

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?

In our view, there are valid arguments in favour of either premise: consistency with the IAS 37 treatment of 'large population' obligations such as product warranty would support the unit of account being the pension plan as a whole, whereas the fact that individual contracts between the entity and its employees are the basis for the obligation would support defining the individual employee as the unit of account. Considering the current discussions on the ED for IAS 37, we do not think that the measurement of the benefit obligation would be materially different, regardless of the unit of account. For example under the current IAS 37 proposal, the probability of a liability will no longer impact its recognition, but will be reflected in its measurement. Therefore it does not matter if the liability is 'more likely than not' for the entire workforce only, but not for an individual employee, as long as the aggregated probability for the entire workforce is equal to the sum of the probabilities for each employee. Demographic assumptions have to be calculated at the level of the entire plan membership, but as long as they can be applied at the level of the individual employee, the unit of account can be the individual employee.

One potential consequence of the individual employee unit of account view is that the concept of curtailment might either become redundant, because it is defined partly in terms of materiality to a plan, or else curtailment and settlement accounting might have to be applied at lower levels of materiality than they generally are under existing IAS 19. If all changes in the benefit obligation and plan assets are recognized immediately and presented within profit or loss, curtailments and settlements would in any case become just one more factor causing those changes, and the specific IAS 19 rules relating to them would be redundant in any case. However, if any other recognition and/or presentation options are permitted, the existing curtailment and settlement requirements would continue to be relevant and the interaction of the unit of account with those requirements would need to be evaluated.

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

We agree.

Chapter 3, Assets and liabilities: reporting entity considerations

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 believe that adopting the conclusions of the DP in financial reporting would give less meaningful and less useful information. Some countries have regulatory regimes under which, according to the IAS 27 definition, an employer might be considered as controlling pension plans it sponsors because it has sole control of investment policy for the plan assets, the right to immediate refund if the plan funded status is in surplus, or both. However, even for these plans, a net presentation of a single liability or asset representing the employer's net obligation or economic benefit associated with its sponsorship of the plan, is more appropriate than a separate, gross presentation of the plan assets on the asset side of the balance sheet and the benefit obligation on the liability side of the balance sheet. This is because any refunds are generally restricted to the amount of the funded surplus. Presenting pension plan assets on a balance sheet line adjacent to financial asset investments or marketable securities which the reporting entity owns directly would be misleading. Disclosure in the notes to the financial statements of restrictions in the entity's ability to access the pension plan assets would not address this potential problem adequately. We understand that users are also unconvinced that a gross presentation would give them better information. A linked presentation, showing plan assets, liabilities and a subtotal for the net asset or liability, could be considered where appropriate.

We would have also liked the DP to explain how consolidation rules would be applied in practice to pension plans. It is not clear to us, for instance, how shared control of the plan by employer and employees would be dealt with, or how investments by the plan in the reporting entity's own equity shares would be accounted for if the plan were consolidated.

Chapter 4, Recognition of pension assets and liabilities

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 accept that the existing 'corridor' deferral mechanism is no longer credible in the eyes of standard setters, regulators and users. Recognition of plan funded status on the balance sheet would converge with US GAAP (FAS 158). It would simplify pension accounting and make it more understandable. However, "immediate recognition" can be accepted unreservedly only if the questions of how the benefit obligation will be measured and of how the resulting changes will be presented in performance reporting are satisfactorily resolved.

Chapter 5, Measurement of liabilities to pay benefits

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 accept that regulatory measures have a different purpose from accounting standards in that the former are concerned with plan governance and security of members' benefits while the objective of the latter is to present fairly the financial position of the sponsoring employer. It is however possible that in some jurisdictions, differences between regulatory measures and IAS 19 valuations could be immaterial.

- ***The discount rate should reflect the time value of money only, and therefore should be a risk-free rate?***
- ***The liability should not be reduced to reflect its credit risk?***

In our opinion, the existing IAS 19 requirement to discount the benefit obligation using the yield on high quality corporate bonds is more appropriate than using a risk-free rate or a credit-adjusted rate. Many users of financial statements now view pension deficits as part of the entity's external financing (borrowings from its pensioners and active plan members), on which an equivalent interest rate must be "paid", inclusive of risk. Measurement at a risk-free rate would approximate a discontinuance or buy-out valuation. Unless a decision to wind up a plan has already been irrevocably taken, that measurement basis would not be consistent with the going concern assumption and would not fairly present the actual position at the reporting date, which must assume the benefit promise does not change and that the plan will continue under the rules and structures which exist at the reporting date. For the same reason, use of a credit-adjusted rate would be equally inappropriate, since this measurement basis implies that the employer may either renege on its benefit promise to the plan members or be unable to honour that promise – again inconsistent with going concern. If the objective is to measure the credit risk of the liability rather than the risk of the reporting entity, plan funded status would have to be included in the measurement of the benefit obligation. Our understanding is that actuaries have reservations about measuring the benefit obligation in this way because it is not clear what valuation techniques would best achieve this objective. For a funded plan, the credit risk relevant to the plan assets is often that of third party asset custodians and investment managers and not

that of the sponsoring employer. A rate based on high quality investment grade corporate bond yields is appropriate for this reason and because, in many jurisdictions, pensions regulators have the power to require entities to provide levels of security for their obligations. We would suggest therefore that the existing IAS 19 requirement be retained.

- ***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?***

We fully accept that users have legitimate needs for further enhancement to disclosures about the riskiness of the benefit obligation. However, the risks and uncertainties in the pension plan cash flows should be taken into account in measurement of the liabilities, not just described in the notes. In theory, this could be done by risk-adjusting the underlying expected cash flows and applying a discount rate which excludes these risks. In practice, we understand that many actuaries are unclear what valuation techniques would be most appropriate to adjust the cash flows for risk. This is a persuasive argument for preferring the present approach whereby best-estimate cash flows are discounted at a risk-adjusted rate.

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

We agree.

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?

In our opinion, in order to present the entity's financial position fairly, the benefit should be measured at an amount that reflects the probability of different outcomes, taking into account the history of recent choices by members. This amount will not always be the highest amount, because employee choices are influenced by their personal and family situations and not just by maximising the present value of their future benefits. Where appropriate, the valuation could be based on an option approach, e.g. valuing the higher promise plus the value to choose the alternative promise, if it becomes more favourable.

Chapter 6, Measurement of assets held to pay benefits

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

This is the existing IAS 19 requirement which, on balance we favour keeping. However, we note that the DP argues elsewhere (see Q4 above) that principles in general standards should be applied to pension accounting. IAS 39 allows not just current (fair) value but also, for certain assets, amortised cost. Since measurement at amortised cost could well be relevant to certain pension assets, we do not understand why the DP does not follow the general principle here.

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

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 with this. However, the divergences which may arise because of the asset ceiling are an important caveat, as the detailed exposition in the DP makes clear. However,

If changes in plan assets and in the benefit obligation are immediately and fully recognized, the asset ceiling may not be applicable anymore. As the asset ceiling rules are complex, this would provide a further opportunity to simplify IAS 19 by removing those rules. The most common reason why the economic benefit to the employer would be less than the IAS 19 surplus of a plan would be if the plan trustees had the power or duty to use the surplus to increase benefits to plan members who are no longer rendering service to the employer. This could be accounted for by increasing the benefit obligation, instead of by derecognising the accounting asset.

Chapter 8, Presentation in the financial statements

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

In our opinion, the following criteria are most important when evaluating the three approaches:

- the resulting presentation should be clear and understandable to users;
- it should maximise the predictive value of the information;
- it should not undermine the relevance of profit or loss as a measure. The relevance of profit or loss is, in our opinion, undermined if there are amounts presented in other comprehensive income which will never be recycled to profit or loss;
- it should be compatible with the cohesiveness principle which is being used in IASB Financial Statement Presentation project discussions.

The DP proposal to recognise all actuarial gains and losses in a separate line in profit or loss, outside operating activities, is not consistent with the cohesiveness principle.

The DP proposal to recognise all actuarial gains and losses immediately in profit or loss as they arise would combine together information with high predictive value, such as current service costs and interest costs, and information with low predictive value, such as actual return on plan assets and period actuarial gains and losses on measuring the benefit obligation. This would complicate assessment of the reporting entity's performance.

For these reasons, we believe that actuarial gains and losses should be presented within other comprehensive income, as under the existing IAS 19 "immediate recognition outside profit or loss" option. Recycling based on parameters which are objectively determinable from the characteristics of the benefit liability, rather than based on the 10% corridor, should also be considered.

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 do not agree. In our opinion, "expected return" could be objectively defined as the return which market participants would expect the portfolio of assets in the benefit plan to earn in the current period, with the balance of actual asset return presented in other comprehensive income. In order to present performance meaningfully, it is surely helpful to show separately what the assets were expected to earn and what they actually earned. An alternative method of distinguishing which changes in plan assets are presented in profit or loss and which in other comprehensive income would be to show unrealized capital gains/losses in other comprehensive income, while interest income, dividends and realized capital gains/losses (including impairments) are presented in the P&L.

Chapter 9, Disclosures in the employer's financial statements

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?

During our discussions with them, financial statement users have highlighted the following disclosure needs not met by existing IAS 19 requirements:

- information on the timing of benefit payment cash flows;
- Average maturity of the benefit obligation;
- Sensitivity analysis.

These needs seem to us reasonable.

Chapter 10, Accounting for multi-employer plans

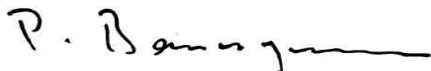
Q13: Do you agree that multi-employer plans should be reflected in an employer's financial statements using the same principles as those that apply to a single employer plan? How, in your view, should an accounting standard require that this be implemented in practice?

While the proposal seems reasonable in principle, its implementation is only possible if the meaningful information for the individual entity's position is available. This is not the case in many multi-employer plans.

Yours sincerely

SwissHoldings

Federation of Industrial and Service Groups in Switzerland



Dr. Peter Baumgartner
Chairman Executive Committee



Dr. Jan Atteslander
Member Executive Committee

cc SH Board