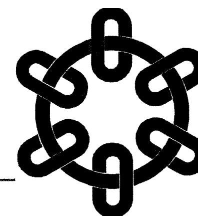
Norsk RegnskapsStiftelse



EFRAG
13-14 Avenue des Arts
1210 Brussels
Belgium

Oslo, June 30th 2008

Comments to the PAAinE discussion paper "The financial reporting of pensions"

Pro-active accounting activities in Europe (PAAinE) issued in January 2008 a discussion paper "The financial reporting of pensions" ("the report" in the continuing). We appreciate the opportunity to comment on the report. This letter expresses the views of Norsk RegnskapsStiftelse (the Norwegian Accounting Standards Board – the NASB).

We do support the work and the initiative of PAAinE in releasing this report. A future enhancement of the principles of financial reporting of pensions is indeed needed and wanted.

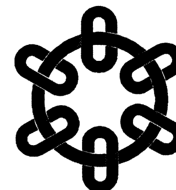
The report has a thorough discussion of pensions, their nature and how they should be accounted for which in our opinion is valuable and adds knowledge, structure and good suggestions to the ongoing discussion.

We would like to summarize our comments as follows:

1. We appreciate the initiative to perform a comprehensive discussion of pensions with a fresh start, in stead of suggesting changes to the current IAS 19 Employment Benefits. However when establishing a new accounting standard with specific accounting regulations for one specific topic one needs an overall framework in which the accounting for pensions can be rooted. Whenever principles in the Framework could be applied for pensions, those should be *overruling*. Moreover, whenever accounting standards/principles exist for similar types of assets and liabilities, those should be applied as long as these standards are based on the Framework and one believes those regulations to be applied also in the future. We do miss more explicit references to the Framework and other existing accounting standards for similar items (e.g. IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 39 Financial Instruments: Recognition and Measurement). Some of the issues related to pension obligations are also similar to the issues of other standards like IFRS 4 Insurance Contracts for life insurance contracts, and to IFRS 2 Share-based Payments for principles regarding allocating the pension cost over the vesting period. The discussion should refer to the principles stated in those standards, and if other solutions are chosen this should be discussed explicitly.

The report addresses this issue in 1.10-1.14. However the focus in the report is more a factual description of the changing environment of accounting. We agree that it is difficult to link accounting regulations for pensions to a Framework and to similar accounting standards when they are under review. However, many fundamental principles/accounting regulations we already today more or less know will not be changed or will only have minor changes. In the areas where changes are expected, one often has a general idea of what the changes will be or at least the alternatives.

Postboks 5864 Majorstuen, 0308 Oslo
Telefon +47 23 36 52 00 – Telefaks +47 23 36 52 02
E-mail: nrs@revisorforeningen.no – Web: www.regnskapsstiftelsen.no



In our opinion a general statement in the beginning of the report stating that pension accounting should follow the general fundamental (existing or expected) principles of the Framework, and secondly apply the accounting principles of relevant and "expected to last" accounting standards treating similar accounting issues would simplify the further discussion. Such a starting point would further strengthen the philosophy of IFRS being a principle based, and not "from case to case" rule based accounting regime. Pension accounting should only differ from the Framework where pensions are special and the principles of the framework or other "expected to last" accounting standards do not apply.

In the same line of thought we very much agree on the statement of the report in S3 that "This paper takes the approach of considering the fundamental principles, which should be common to all pension plans"; eliminating the need for drawing sharp distinctions between defined contribution and defined benefit plans.

2. The report uses the term "pension benefits". We believe the discussion should be based on the perspective from the entity, and hence "pension obligations" should be used. This is also in line with the terms used in the Framework.

3. Chapter 5 and 6; Measurement of liabilities and assets
The Framework lists four different alternative measurement bases; "current cost", "settlement amount/realisable value", "present value" (which is actually not a measurement principle but rather a technique of measuring "value in use") and "historical cost" ("fair value" or market value is not mentioned directly in the Framework, but should be included as a fifth measurement alternative as the standards have developed).

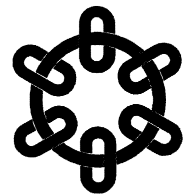
The discussion of measurement in chapter 5 should end up choosing one of these measurement bases and use the same wording/terms. A phrase like "A current value measure will be a settlement amount" is not consistent with the Framework and other current IFRS terminology.

The main discussion seems to be whether fair value or present value should be used. As Q4 states, pension assets and pension liabilities are separate risks and should be presented and measured separately. Hence they *could* also be measured using different principles.

Pension assets should be accounted for at fair value. The problem is that fair value, before we have the conclusions of the current fair value measurement project, is not a defined term under current IFRS. Pension assets are (almost always) financial assets or real estates, and hence should be measured accordingly. Thus, based on current regulation, financial assets should be measured at fair value in accordance with IAS 39. For real estates the measurement should be at fair value in accordance with IAS 40 Investment Property.

The difficult question is which measurement basis should be used for pension liabilities. We are of the opinion that pension liabilities are preferably to be measured at fair value. The key question is how this measurement attribute is to be applied when active markets for pension liabilities do not exist? Then proxies for fair values/market values (like present values) would be the solution in today's world where active markets do *not* exist (similar to valuation of not-ready-to-harvest fish as biological assets under IAS 41 Agriculture). The proxy measurement method would be the present value of the expected cash flows; in theory the value equal to market value in an active, efficient market with full information.

The alternative measurement method seems to be the present value of the most likely event or weighted events, similar to measurement of provisions; IAS 37. The result would be the same in today's situation where there are no active markets; the present value of the expected (probability-weighted) cash flows.



However, from a principle based perspective choosing fair value (and then; present value method as a proxy as long as active markets do not exist) *or* the present value of expected cash flows is a major difference that might lead to different results.

Moreover, the market price in an *active* market would most likely be different from the present value of the entity specific cash flows: In a market place an external buyer would need a premium for not having influence on the size of the liability, because he could not negotiate directly with the employees. On the other hand he could eliminate diversifiable risks by having a large portfolio of many pension liabilities and other investments. The entity with pension liabilities has influence on the size of the liability in many ways; turnover, disability, even mortality by implementing safety/healthy working conditions etc. and has influence on salary increases and might even renegotiate earned pension rights for the employees. It is probably not possible to even establish a hypothetic market for pension obligations based on final salary level. Hence pension liabilities have more similarities with provisions than with tradable liabilities. For other pension obligations with a defined future amount, a market value approach would however be appropriate.

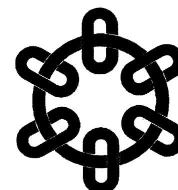
Hence we conclude, under doubt, that a pension liability has characteristics more similar to provisions than to financial instruments, and hence that present value of expected cash (out)flows is the preferred measurement method.

An alternative view is that a post employment liability, depending upon the specifics in the post employment promise, might in fact have characteristics that are partly financial liabilities, insurance liabilities, [vested and or unvested] non-financial liabilities (provisions) or even in rare cases non-financial assets. This view would then go on to say that a post employment liability, for recognition and measurement purposes, is to be separated into unique components that separate each characteristic and that the recognition and measurement of each such component should be based on the recognition criteria and fair value measurement method described in relevant standards for each such component.

4. *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)?*

We disagree with the proposal of not including future salary increases in the calculation of current pension obligations if such future salary increases are expected to influence future expected pension payments from work performed as of the balance sheet date. When considering a pension obligation, the first question is whether the pension obligation is a liability to be recognised in the balance sheet. If the pension obligation is a liability, the next question is how to measure the liability. The alternatives are the present value of the most likely event, the present value of the weighted average of many events, or the fair value of the liability (see the discussion above in 3 and below for a further discussion). If pension obligations should be measured at fair value, it is evident that the effect of future salary increase needs to be included, as the market price in a deep market would reflect the terms of the obligation. If a present value approach is chosen, the effect of future salary increases needs to be included in order to reflect the best estimate of the future cash outflows for servicing the pension obligation. This is also the case in many other estimates in accounting, e.g. in measuring provisions under IAS 37. Often provisions, measured at the present value of the most likely or expected cash-outflows involve estimating the effects of future events where the entity has more or less influence on those future events; the success of the negotiation of a claim settlement, the technical and practical solution to a pollution-problem including development in new technologies, cost of labour to perform the work and so on. We see no reason why pensions should be treated differently.

The report uses the same line of argument when it reaches the conclusion in S6 that also unvested benefits should be included in the measured and recognised liability; because this is the expected outcome/most likely event when estimating the liability. Not measuring the expected costs and the best estimate, even if these estimates include the effects of future events, would be in violation with



similar types of liabilities and provisions. In our view the current IAS 19 BC 35-37 gives relevant arguments for taking assumed future salary increases into account when measuring the obligation.

If a fair value measurement method is to be used, a willing buyer of the liability would never accept to buy the liability without being compensated for the expected increase in pension-payments caused by the future increase in salaries. If you compare two otherwise similar entities in a similar economic environment; one with a pension scheme giving the employees a future pension benefit of 60% of today's salary and the other entity with a pension scheme giving the employees a future pension benefit of 60% of the salary at the date of retirement, it is quite obvious that the latter entity today has a higher pension obligation than the first entity. Moreover, for final salary plans, the employer is obligated to pay pensions based on the salary level at or near the retirement date and normally the employer is not able to be released from this obligation without consent from the employees covered by the pension arrangement. We thus believe that to base the pension obligation only on the salary level at the balance sheet date will not be in accordance with a balance sheet approach.

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?

We believe that this issue should be treated in the same way as other provisions. The entity has a liability to the individual employee, as the employment contract is with each employee, and thus the liability is owed to each employee. However, for practical purposes, it should be accepted that certain assumptions could be based on assumptions for the work force as a whole, i.e. expected salary increase and expected turnover.

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

If fair value measurement is chosen this would theoretically not be an issue. However, as we deem it necessary to use the present value method as an approximation to fair value, it will be necessary to establish methods for allocation of the total pension liability over the service period. One might argue that some sort of salary weighted distribution technique could be established, but that is something else than disregarding the expected future salary increases.

6. *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 do agree that pension plans should be subject to the same principles of consolidation as other companies under the entity's control.

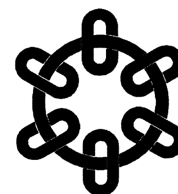
7. *Question 5: Do you agree that changes in assets and liabilities relating to pension plans should be recognised immediately, rather than deferred and recognised over a number of accounting periods or left unrecognised provided they are within certain limits (a 'corridor') approach?*

We do agree that changes in assets and liabilities relating to pension obligations should be recognised immediately. This is in line with the development we have seen in IFRS in recent years e.g. regarding financial instruments, provisions, and is in line with the Framework. One relevant questions is however how to present the changes in the financial statement (see discussion below).

8. *Question 6: 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 that measures should be based on general accounting principles.

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



We disagree with using a risk free rate as the discount rate for pension liabilities. Pension liabilities have risks that are not diversifiable; e.g. long term salary increases, long term mortality development etc. The discount rate should reflect such risks.

- 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?

When measurement is based on present value method, reputable methods for discounting future cash flows should be applied. In all finance theory and most IAS/IFRS-accounting standards this involves using a risk adjusted discount rate, or adjustments of the projected cash flows in order to reflect the risks. This is not specific to the measurement of pension obligations. Other accounting standards, such as IAS 37, IAS 41, IAS 17 Leases, IAS 36 Impairment of Assets etc, face the same problem of finding the correct risk adjustment, but still the standards require the use of risk adjusted discount rates or risk adjusted cash flows.

In many areas of accounting measurement is problematic, uncertain and subject to judgement (bad debt, obsolescence, net realizable value etc), but this does not relieve the entities from the requirement of the accounting standards to perform a best estimate measurement. Risk adjusted discount rates are even well supported by finance theory and empirical data.

Hence we do not agree that the riskiness of a liability is best conveyed by disclosures. The riskiness of the liability should be reflected in the measurement of the liability, like for all other items in the balance sheet. However, additional disclosure of the riskiness is important information in order for the reader to evaluate the book value of the liability.

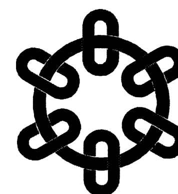
In our view there is a need for a fundamental discussion of what an appropriate risk adjustment implies for the measurement of obligations. Risk adjustments related to liabilities should be rooted in academic theory. Let's assume measuring an entity's value in use according to IAS 36. The entity is an oil producer and has a large dismantling obligation at the end of the production period. When measuring the value in use the best estimate of the future dismantling cost is included in the cash flow projection, and is – together with all other cash flow projections – discounted with a risk adjusted discount rate (the risk adjustment is decreasing the present value of the future cash flows). The reason for not separating the discount rate for in- and outflows of cash is that it is the net amount of cash that flows to the entity, and that the risks of the cash flows are hedging each other. But it is straightforward to conclude that when measuring a future obligation the risk adjustment should be opposite (i.e. increasing the present value of the future cash flow). We have reviewed finance theory without finding support for any of the views discussed in the report, and hence we would encourage PAAinE to review this particular question in further detail.

Based on our discussion above, we conclude that the discount rate when discounting estimated cash flows for defined benefit obligations should *always* reflect risk; this should not depend on whether there are actively traded high quality corporate bonds or not in the country. Such measurements should only be guidelines, not binding values to be used as the current IAS 19 states in 78-81.

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

As stated earlier in our comment letter, we believe such issues should not be discussed separately for pension liabilites, but should be aligned with the conclusions reached in the on-going fair value measurement project, the updated Framework and other updated accounting standards as IAS 37,

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



We agree that future expenses of administering the plan's accrued benefit, still not paid for *should* be reflected in the liability. This might be the case when the entity must continue to pay expenses over the period the pensions are paid.

9. *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 highest amount should be used as the recognised liability for the entity when an external party has an option to choose. When external parties have options to choose between different benefits from an entity, they should be expected to be rational, and hence they will *always* choose the options with the highest value for them. Hence the highest value will always be the only realistic liability and should be chosen. An option pricing model might be relevant in measuring the value of the option to choose scheme at the date of retirement.

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

See above. Pension assets should be measured at fair value as defined in other relevant accounting standards (e.g. IAS 39 or IAS 40).

11. *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?*

This is a question related to one specific pension arrangement. Our first comment is that actual country-specific arrangements should not be addressed in a report addressing the fundamentals of pension accounting. Such issues should be discussed based on principles and independent guidelines, established as a result of the fundamental review of the accounting for pension obligations. Concluding on specific arrangement in one country might also lead to wrong conclusions for other similar entities in other countries, as the fact pattern could contain minor, but vital differences.

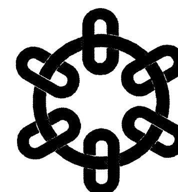
If we understand this correctly, the entity in this case does not have the full risk nor control of the pension assets or the pension liabilities respectively; it only has the liability for the *residual* if the separate trust lacks assets to settle the pension payments at the time of payment. Hence it is not (separate) assets and liabilities for the entity. There is only a residual obligation/guarantee/ contingency, and a provision for this should be made "net". The main question is however whether the entity at the end of the day bears the risk for the gross exposure of the benefit obligation and the plan assets.

In our opinion this is not only a measurement issue as the chapter states, but a definition of an asset/ liability issue, then a measurement issue and finally a presentation issue.

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

We agree that it is necessary to present separately the different components of expense. However, we believe that it is premature to decide upon which components that should be presented separately. This issue should be looked at in the light of the development of financial performance presentation in accordance with IAS 1.
One issue the paper does not address is the presentation in the balance sheet. Pension assets and pension liabilities have different risks, and the liability and the assets cannot and should not be offset. A gross presentation in the balance sheet should correspond with a gross presentation in the profit and loss statement.

13. *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 financial performance of an entity should reflect the actual return on assets.

14. *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?*

It seems as if the disclosure issues have not been as comprehensively discussed as the other issues in the report. Either more work should be put into this, or it should be removed from the report. The final standard should include comprehensive disclosure requirements.

15. *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?*

We agree that the same accounting principles should be used to reflect multi-employer-plans as single-employer plans.

However, we do not agree with the alternative approaches suggested as surrogates; the alternatives would lead to very different values. If proxies are used for the preferred measurement methods, because the data are not available, the surrogate/proxies should only be simplified methods to arrive at values which should give the same result as if correct data where available. The accounting standard should set out the principles, and the preparers should measure the pension obligations at their best estimate using the information available.

16. *Question 14 and 15: 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?*

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?

In our opinion pension plans should in principle use the same accounting standards (definitions, measurement and recognition) as (life)insurance-companies, as long as insurance companies use accounting principles according to the Framework and the "normal" accounting standards for assets and liabilities where applicable. This should be solved within the IFRS 4 project, and should not be included in this report.

Yours faithfully
Norsk Regnskapsstiftelse

pp Siri C. Rosenblad

Erlend Kvaal,
Chairman of the Technical Committee on IFRS