Date

1 August 2008

Le Président

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Dear Mr. Enevoldsen,
Dear Mr. Mackintosh,

Re: <u>Pro-active Accounting Activities in Europe (PAAinE) - Discussion Paper on the Financial Reporting of Pensions</u>

1. FEE (Fédération des Experts Comptables Européens, Federation of European Accountants) is pleased to submit its comments on the Discussion Paper on The Financial Reporting of Pensions ("the DP"), led by the Accounting Standards Board (ASB) in collaboration with EFRAG in partnership with European standard-setters.

2. We welcome the PAAinE initiative to provide a European contribution to the debate on the financial reporting of pensions. We agree that financial reporting of pensions continues to be a matter of concern worldwide and gives rise to challenges for financial reporting. A European contribution to this debate is essential. We welcome the fundamental reconsideration the DP represents for the accounting of pensions. The DP summarises the critical conceptual arguments for various approaches and therefore is in our view a very good starting point for this fundamental review and a basis for future changes of the current accounting method for post-employee benefits.

3. We welcome the DP's objective to seek a fundamental reconsideration, starting from first principles, of the accounting that should be required for pensions. We appreciate that the views set out in the DP have been informed by the IASB Framework.

4. However, we believe that the situation where the risks inherent in the pension plan are shared between the parties involved (employer, employees, former employees and retirees) is not being addressed. Such plans will result in variable benefits for the plan participants. In the DP we did not recognise a situation comparable to a variable benefit plan. In particular, the potential risk for the employer is not discussed. We believe that PAAinE/ASB should give these plans more consideration. Appendix 3 includes a document setting out the situation in the Netherlands to describe the main features of such a variable benefit plan and the Dutch views on the way such a plan could be accounted for as an illustrative example.

5. In addition, we suggest that the DP be further developed to clarify certain key notions such as:

   - Some state plans and some multi-employer plans which may require further consideration, especially when the promise to employees is of a defined benefit nature, but the employer only has an obligation to contribute on a pay-as-you-go basis, based on their current workforce. Appendix 2 includes a document setting out the situation in the Netherlands to describe the main features of such a state plan and the Dutch views on the way such a plan could be accounted for as an illustrative example;

   - Measurement inconsistency between assets held to pay benefits (assets of the sponsoring entity) and other assets of the same nature held for other purposes (see Question 8);

   - Consolidation issues (see Question 4).

6. We understand that the paper does not explore sector-specific issues in detail.

7. Our responses to the questions in the Invitation to comment Section of the DP are contained in Appendix 1 to this letter.

We would be pleased to discuss any aspect of this letter that you may wish to raise with us.

Yours sincerely,

Jacques Potdevin
President

Ref: ACC/JP/SS/LF

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)?

1. We have some reservations to accrue pension benefits in the current period based on future salary increases that are by definition not taken into account in the current employee wages. Some believe that the approach developed in the PAAinE document to measure the obligation based on current salaries appropriately addresses this issue. However, others are not convinced that this is the right way to handle this issue because of the conceptual issues it raises as explained here below.

2. The projected credit unit method, as currently prescribed by IAS 19, assumes that the obligation at the balance sheet date corresponds to the portion of the benefit that will eventually be payable for services already rendered, this portion being determined according to the benefit formula or on a straight line, if the benefit formula attributes higher benefits to future periods. We believe that it is consistent with this methodology to measure the obligation taking into account all parameters that will influence the level of the final benefit, provided these parameters are agreed between the employer and its employees, either as part of a contractual agreement or as a result of a constructive obligation.

3. In this context, it appears inconsistent to exclude future salary increases from the measurement of the projected benefit. If an entity has promised to its employees that their pension benefits will be based on their final salary, this means that the entity has promised to revalue the rights relating to past services continuously during the working life of its employees. Alternatively, the entity may have promised an indexation based on the average salary increase during the same period. Yet, the paper proposes to treat these two schemes differently on the basis that the final salary of an individual remains, to a certain extent, within the control of the entity since it has discretion in granting part or all of these salary increases in the future. However, we do not believe that this is really a matter of discretion, as generally an entity will generally not decide whether to grant a salary increase in the future solely on the grounds of increased pension obligations relating to past service. In deciding such salary increases, the entity will take into account other factors, such as the nature and importance to the entity of the future services of the employee. In other words, if an entity decides to increase the salary of an employee in the future because the services he or she renders require this increase, then the entity will also be obliged to accept an increase in pension obligations.

4. Furthermore, excluding discretionary salary increases appears to be based on the premise that the entity is not presently committed to provide the related benefits to its employees. We do not believe that it is the case, because the entity is committed to revalue the pension benefit each time the salary increases, as a direct consequence of the plan agreement. Considering that the entity is not currently committed to give this part of the benefit would result in treating salary increases as a kind of plan amendments. Currently, the only aspects that are not taken into account in the determination of the benefits are those that are not contractual, and for which no constructive obligation exists. Further, the projected unit credit method requires that some increases in the cost of the benefit are incorporated in the calculation and that this amount is discounted. Ignoring future salary increases could lead to an internal inconsistency in the measurement of the obligation, since inflation has an influence on both future salary increases and discount rates. Finally, distinguishing the amount of salary increase that is to be retained in the measurement of the obligation is likely to be difficult and the paper does not really provide elements that could result in a principle based approach in

assessing how to distinguish the salary increases that should be considered from those that should be ignored.

5. Those who do not agree with the approach proposed in the PAAinE paper believe that the key issue in the treatment of salary increases is not whether they remain at the discretion of the entity but rather that it is an issue of allocating the benefits to the appropriate periods of service. The current linear basis appears to have been influenced by prudence consideration. They propose that the pension liability should be attributed to periods of service with a pattern that reflects the increase in salaries due to staff evolution within the entity rather than on a linear basis. Therefore, we recommend investigating further ways to better allocate the liability in order to find an appropriate solution to address the identified issues.

6. This discussion is similar to that on participating insurance contracts in the Insurance Project for which it is argued that the recognition criteria should not be applied to individual elements of an obligation, but discretionary payments would need to form part of a measurement of the recognised obligations.

7. The basis of recognition of the liability depends on the kind of obligations included in the plan. A distinction should be made between pension plans that are based on average pay and final pay.

   For average pay plans, we believe that the present obligation should be based on the current salary as it includes only benefits that the entity is presently committed (by legal or constructive obligation) to pay. A liability (and expense) does not arise in respect of future increases in benefits until the entity is committed (by legal or constructive obligation) to pay them. However, in case of benefits that vest only at a future date (for example on retirement), we do not think that taking into consideration only the current salaries is the only way to measure the obligation. We consider that this could be viewed as an issue of allocating the benefits to the appropriate periods of service (as in paragraph 5).

   For final salary plans, we believe that the present obligation should be based on expectations of employees' pensionable salaries when they leave service. It includes the expected future salary increases as the entity is committed to a pension based on expected salary at pension date.

   We believe that the liability should also include increases in the pension obligation due to indexation of the pension payments (with e.g. the general wage increase) if the company is committed to these increases by an agreement.

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?

8. The pension liability cannot be deemed to be owed to the workforce as whole, since it results from a contractual relationship between an employee and an entity, and some terms are usually specific to an individual employee. However, we consider that this analysis should have no consequence for the recognition of pension benefit obligations: the obligation to give pension benefits is a matter of fact and depends on the existence of a contractual and/or constructive obligation to pay benefits. We believe that the challenges of pension cost measurement are better served by a portfolio approach, such as the one currently described in IAS 19. This portfolio approach, rather than being based on an average notion, could

be improved by introducing systematically a weighted average approach whenever the impact is material.

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

9. We agree in principle that the liability should only reflect present obligations existing at the balance sheet date. We believe that a liability exists even when pension benefits have not yet vested, because the entity is committed to grant benefits relating to past service if those benefits finally vest, and the vesting is not wholly within the control of the entity. Generally, an entity would not decide to terminate an employee with the sole objective to avoid paying pension benefits. The difficult issue with pensions is the measurement of the liability at the balance sheet date, and particularly the attribution of part of a future total cost to past services (see our answer to Question 1). Therefore we emphasise the need for a comprehensive debate about the principles to follow for the attribution of the pension obligation to years of service.

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?

10. We agree that entities created to fund pension plans should not in principle be excluded from the scope of consolidation standards.

11. However, we acknowledge that the current consolidation standards and interpretations do not sufficiently take into account the specificities of such entities and that it may be difficult to conclude on the basis of the existing literature. Currently, the consolidation project of the IASB does not appear to address issues particular to pension plans. Therefore, rather than drawing conclusions from the current state of the discussions, we believe that it would be useful to determine first if the tentative decisions of the IASB Consolidation Project are meant to apply to pension trusts, and to what extent they should be modified or adapted to the specificities of pension trusts.

12. In effect, depending on the statutory or contractual provisions of the agreement, the governance of the trust may be more or less independent of the sponsoring entity, but frequently the employer will bear the majority of the risks relating to the pension assets, and most of the time will keep control over the nature and amount of the pension benefit. We are not convinced that the only element to take into account in the consolidation analysis is who has control of the investment strategy: the fact that the investment strategy may be controlled by the trustees is insufficient ground to presume they control the assets and liabilities in the fund. Further, as employees are not affected by the results of this investment strategy (because of the defined benefit nature of the promise and the obligation for the sponsoring entity to support the fund), we fail to see who would have the control over the assets and liabilities of a pension trust. It is not always evident where real control of the assets and liabilities of the trust lies.

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?

13. Yes, we agree that there is no conceptual basis for deferral of actuarial gains and losses. However, we believe that the decision to remove deferral mechanisms should be considered together with measurement and presentation issues to ensure that the concerns expressed by constituents and the IASB when developing and revising IAS 19 up until 2004 are addressed (see response to Question 10).

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?***

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

- ***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?***

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

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

14. We agree that regulatory measures should not replace, in the financial statements, measures derived from general accounting principles. Nevertheless, we acknowledge that, in some jurisdictions, regulatory measures must be used to determine the funding obligations of the sponsoring entity, and that this may affect the financial position of the entity. In this respect, we consider that IFRIC 14 appropriately deals with the interactions between regulatory funding mechanisms and accounting requirements. Furthermore, regulatory requirements may affect the timing of the cash flows, and this is important with respect to the objective of financial reporting.

15. We believe that the risks specific to the pension liability should normally be taken into account in the projected cash flows, using an expected value approach (weighted average of possible outcomes) and that the discount rate should be a risk free rate. We acknowledge that such an approach may be costly to implement in practice and that IAS 19 adopted a "most probable outcome" approach instead. If the latter approach is kept for a new standard on pensions, we consider it inappropriate to factor into the discount rate the risks on cash flows, as it is likely to be an arbitrary adjustment. Therefore, we agree that a risk free rate should be used, supplemented by disclosures in the form of sensitivity analyses as this would provide useful information about the risks relating to the liability.

16. We consider that the discount rate should not incorporate the entity's own credit risk. Firstly, in the perspective of the going concern of the entity, the liability will be settled over time through the payment of pension benefits. Of course, where there is a tradable market, the factors to be taken into account in valuations could be different. However, the current infrequency of "buy-outs" would suggest that credit risk is not an appropriate generic approach to valuation. Therefore we do no believe that the credit rating of the entity should affect the amount of the obligation owed to employees. Second, to the extent that funds have been set aside in a bankruptcy-remote entity, we fail to understand how the credit rating of the sponsoring entity would be relevant.

17. Expenses of administering the plan's accrued benefits form part of the obligation of the entity to provide benefits relating to past service and therefore should be included in the measurement of the liability. However, it may be difficult to distinguish the expense relating to past service from other expenses.

18. Even if we agree with some of the proposals in the DP, we would like to draw your attention to the fact that these proposals appear to conflict with the conclusions reached on other IASB projects, such as the revision of IAS 37, fair value measurement and insurance contracts. On the discount rate, we do not feel that there are sufficiently developed arguments for or against having a risk free rate. We think that the paper needs more work in this respect. This additional work could be made as part of these other IASB projects.

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?

19. We support an approach based on the probability of different outcomes, especially because the choice of the employee will not necessarily be driven solely by financial objectives (if this was the case, then all employees would systematically choose the option with the highest value).

20. The FEE response on the IASB Discussion Paper on Insurance Contracts rejected measurement of liabilities under a worst cases scenario for the behaviour of policyholders.

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

21. Yes, we believe that assets held to pay benefits should be measured at current values at the balance sheet date since those assets are only held for the purpose of settling the obligation, and the liability is also measured at current value. The consistency of the measurement basis provides useful information about the financial position of the entity at the balance sheet date.

22. However, if assets held to pay benefits are considered as assets of the sponsoring entity, the justification for a specific measurement requirement for such assets should be developed. In effect, the sponsoring entity may have a number of assets of the same nature, only some of which are held to pay benefits. Therefore, if assets held to pay benefits are reported at current values, there will be a measurement inconsistency with other assets of the same nature held for other purposes, such as investment properties or held to maturity financial instruments.

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?

23. The discussion of this issue should be expanded to include a description of the nature of the sponsoring entity's obligation based on the terms and conditions of the arrangement and/or legal requirements. For example, are there situations where the obligation is more in the nature of financial guarantee? We believe that in most cases the entity will remain the primary obligor towards employees, the trust being merely a way (defined by law or contract) to secure the pension promise. The independence rules governing the trust may be viewed as limiting the

control of the sponsoring entity over the assets, without discharging the entity from its obligation to pay pensions to its employees.

24. The DP first explains that a net asset or liability arises when the entity only has the obligation to fund a deficit but the trust has the obligation to pay benefits. Then it proposes to measure the net asset or liability at the same value as if the entity had accounted for separately an asset and a liability. This approach appears to be inconsistent: the recognition of a net asset or liability implies that the entity does not have an obligation to pay pensions nor does it have the assets that it will use to settle this obligation, but rather that the entity has a net obligation that may be akin to a guarantee given to the trust. In this situation, we would expect that the liability would be measured applying the accounting requirements applicable to guarantees, rather than those applicable to pensions. We believe that concluding that the measurement should be the same is an indication that the financial position of the sponsoring entity is the same and therefore we fail to understand why this financial position should be presented differently based on the legal form of the arrangement.

For additional considerations on disclosure, see response to Question 10.

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

25. The answer to this will differ depending on whether there should be net or gross presentation on the balance sheet, as we believe that there should be some minimum level of coherence between the presentation in the balance sheet and income statement.

26. Therefore, we would agree that the different components of changes in liabilities and/or assets be presented separately in the income statement, but only when the presentation of the assets and liabilities on the balance sheet is gross.

Net presentation on the balance sheet

27. In this case, we would support presentation of the change in the asset or liability within one caption in the income statement.

28. If the logical reasoning of the DP is that net presentation on the balance sheet is used when the company is believed to have no direct obligation towards its employees to pay pensions, it would appear inconsistent to present the elements separately on the face of the income statement.

29. It is difficult to draw a conclusion before we know the IASB decision on whether in the future there will be one income statement only.

30. However, we agree that disclosing further information would be relevant in order to gain a good understanding of the various elements of the plan, their nature and the risks associated with them. For instance, it would be useful to provide information to explain how the net position has altered from prior year. This information could be given in the notes or/and in the management commentary.

Gross presentation on the balance sheet

31. If the presentation of the assets and liabilities on the balance sheet were gross then we would agree with a presentation of the changes in the assets and the liabilities of the pension plan in different captions in the income statement.

32. However, it would be useful to clarify the reasoning for the classification of actuarial gains and losses under other financial performance, while changes in fair values would fit under financing as there are some relationships between the measurement of the liability and the discounting (inflation notably). In order to maximise consistency, we consider changes in fair value of certain assets (for instance financial instruments) should be classified together with actuarial gains and losses with in one caption.

33. The conclusion reached for actuarial gains and losses does not seem to be consistent with what is currently done for other types of long term liabilities, where changes in estimated cash flows are usually not presented separately. The IASB Discussion Paper Preliminary views on amendments to IAS 19 Employee benefits, considers that actuarial gains and losses relating to demographic assumptions are remeasurement of the service cost and should be presented together with the service cost.

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?

34. To the extent that all variations in the pension obligation are recognised immediately when they arise, we do not see the relevance of continuing to identify an expected return on assets. Therefore we consider that the financial performance of an entity should reflect the actual return on assets.

35. Furthermore, we do not believe that the calculation of an expected return on assets can be made totally free of bias (for example in the case of shares, the calculation of their expected return would be very subjective).

36. Instead of disclosure of the expected return (number) in isolation, we recommend that detailed information also be given on the investment strategy used and the type of assets owned in order to give sufficient information to the investors on the expected return.

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?

37. We think that users of financial information expect that management would disclose useful information on the policies and assumptions that relate to the pension plans, as well as information on any issues that are specific to the particular plans that the employer has entered into. Accordingly, we broadly agree with the disclosure objectives described in the paper.

38. However, we would have expected that more emphasis would be put on the objective to provide information about future cash flows, and the variability of such cash flows as a result of any changes in the underlying assumptions (for example changes in the information relating to the demographic factors used).

39. In particular, requiring some type of liquidity risk disclosure, consistently with the current requirements of IFRS 7, would be useful to users of the financial information.

40. Furthermore, we do not believe that it is appropriate to give several measures for the pension liability, either within the financial statements or in the management commentary. This is likely to be troublesome for users, and accounting standards do not usually require giving different measures of assets and liabilities in order to allow different users to choose the one they find suitable for their needs. Rather, we believe that sensitivity analyses and cash flow projections should help understand the complex characteristics of pension promises and related funding schemes.

41. However, if a statutory measure is used to determine the funding requirements of a particular scheme, then a disclosure should aim at giving users an understanding of the way the statutory requirements will affect the cash flows, rather than simply giving an additional measure.

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?

42. Based on the country examples below, we query whether the nature of the liability in a multiemployer plan is the same as in a plan specific to an entity. As stated in the paper, the participation to a multiemployer plan generates other risks that are not related to one specific entity and its employees. Further, there is some sort of sharing of risks and lots of industry wide plans work as state plans in the sense that entities are only committed to pay a percentage of the current salary of their employees, with no further obligation. If it is concluded that the liability in this kind of arrangement is identical to the one in a plan specific to an entity, then it is likely that some state plans will also need to be considered as requiring the same accounting

43. There may be specific circumstances where this may not always be workable in practice. For example, in some countries there are currently many multi-employer plans that are state plans, for which only information on current contributions are required to be provided. We are not convinced that requiring the use of the same principles as those that apply to a single employer plan would be appropriate in these circumstances. In some cases, we note that overall disclosure for the multi-employer scheme under IAS 26 may be the only information available. In Sweden, there is a nation wide pension plan that most employers are part of and that is accounted for as a multi-employer plan. All employers have concluded that there is no basis to account for this plan as a defined benefit plan due to the fact that there is a lack of sufficient information to use defined benefit accounting. Accordingly, all companies in Sweden account for this plan as a defined contribution plan. In that specific case, there is no reasonable basis to allocate assets or liabilities to the participating entities within the Swedish pension plan. The reason for this is that it is not possible to determine from the terms of the plan to which extent a surplus or a deficit will affect future contributions.

44. In addition, even if it was possible to apply always the same principles in practice, we think that it may not always be straightforward to decide on the share of the risks that are to be allocated to each employer in the plan. Individual employers in a multi-employer plan may not always have the same risks, and it may not always

be clear or easy to decide on the share of the risks, because for example one entity's headcount is expected to grow faster that the one of other entities in the scheme and therefore the share of the growing entity in the obligation is likely to increase. We are not convinced that a share of assets and liabilities of the plan can be determined except arbitrarily.

45. We doubt whether there should be an accounting standard requiring the same principles in practice, without any exceptions for specific circumstances of multi-employer plans taken into consideration. In practice, there is not only one single type of multi-employers plan, so the application of the same principles may not always work in practice or be the most appropriate requirement.

46. We believe that multiemployer plans, as well as state plans, should be further investigated to determine the nature of the liability, even if as a general principle, we would 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. For example, we believe that the analogy with IFRIC 6 Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment should be further considered.

47. Because of the mandatory participation, employers may consider the premiums that they have to pay to a collective pension fund in the same manner as the premiums levied by the state to execute a general old age state plan. As is the case in state plans, the collective plans are not subject to control or influence by the individual reporting entity (IAS 19.37) while the only obligation of the individual entity is to pay the contributions as they fall due. Like in state plans, if the entity ceases to employ members of the collective plan, it will have no obligation to pay the benefits earned by its employees in previous years and the entity has no legal or constructive obligation to pay those benefits in the future.

48. In such a collective scheme, the individual employers are not promising pension benefits to their employees; rather they are promising to pay premiums to a collective scheme that operates the collective employee benefit plan. The promise to the plan participants is made by the Board of the plan by way of communicating the relevant pension terms to all the participants involved. In exchange of the services provided by the employees, the employer pays the determined premiums to the scheme and promises to continue to do so in the future.

49. Please refer to Appendix 2 for an example of a multi-employer plan (mandatory collective employee benefit plan), effective in the Netherlands.

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?

50. We note that up to now, most pension plans do not prepare general purpose financial statements under any specific GAAP, so the requirement to prepare such financial statements for these plans would represent a major change.

51. We further observe that a large diversity of pension funds exist in various jurisdictions. Sometimes, these entities are merely administrative vehicles used to safeguard the assets. We do not believe that there should only be one answer since the appropriate answer depends on the nature of the role of the pension trust assigned by contract or legislation. This issue is linked to the point made in our

answer to Question 9: there may be situations where the pension trust bears the obligation towards employees and other cases where it is simply administering the assets. It is not obvious that assets and liabilities of the pension trust would be the same in both situations.

52. For example, in Sweden, the pension promise is given by the employer and the pension fund is an administrative vehicle used to safe guard the assets. The pension fund does not have any obligation to pay out benefits to retirees in the future. In fact, it is prohibited from doing so. The employer has the commitment and pays the benefits to all its retirees directly. Thereafter, the employer is entitled to request reimbursement from the pension fund by the same or a smaller amount, if the employer desires. Accordingly, all pension funds in Sweden have only assets and equity in their balance sheets (no liability).

53. However, in certain cases, it may be appropriate to produce financial statements showing assets and liabilities. In these cases, we do not see why applying IAS 26 would not be sufficient. In these cases, we would consider that applying the same basis for measurement to present an employer's liability and a plan's liability would make sense even if, in practice, we believe that this may not always be the most appropriate reflection of the amount of the liabilities, if the plan does not have the same control as the employer over the pension promise. Therefore, while we agree in principle that the plan's liabilities for future benefits should be quantified using the same principles as an employer's liability, we also think that specific considerations should be taken into account when the control over the promise differs and the nature of the liability differs.

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?

54. Our main concern is the reflection of an asset in respect of amounts that are only "potentially" receivable. In practice, it may be difficult to account for this type of assets if we are uncertain what they are. How to account for this is the key issue. We believe that the accounting for this will depend on the type of agreement (or covenant). It would be helpful having a clear definition of the agreement to which the proposal to reflect this type of asset would apply.

55. If the amounts receivable represent a known commitment, then it would seem straightforward to quantify this asset and account for it. However, if there is only some kind of general support for amounts that are potentially receivable, we agree that this would be useful information to have. However, it is questionable if it should be recognised as an asset.

56. The determination of the nature of the asset to be recognised, and of its basis for measurement, would involve the same analysis as that discussed in our response to Q9 where we raised the need to determine whether the obligation of the employer is of the nature of a financial guarantee.

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.

57. As noted earlier, some state plans and some multi-employer plans may require further consideration, especially when the promise to employees is of a defined

benefit nature, but the employer only has an obligation to contribute on a pay-as-you-go basis, based on their current workforce.

58. Please refer to Appendix 3 for an example of a so-called variable benefit plan, effective in the Netherlands.

Features of mandatory collective employee benefit plans

1. A mandatory collective employee benefit plan is a specific type of a variable benefit plan. All the features of a variable benefit plan as described above apply as well to mandatory collective employee benefit plans. In addition the following features are inherent in a mandatory collective employee benefit plan.

2. Mandatory collective employee benefit plans are plans in which various entities are involved that are not under common control. The plan pool the assets of the contributing entities and use those to provide benefits to employees and former employees of the entities on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employe(d)s the employees concerned.

3. By law or collective labour agreement employers are **obliged** to pay contributions to the scheme; sometimes it is possible for a sponsoring employer to opt out of the scheme, but only if there is a company pension fund or insurance scheme that offers terms that are at least equal to those of the compulsory scheme.

4. If the entity ceases to employ members of the collective plan, it will have *no obligation to pay* the benefits earned by its employees in previous years and the entity has no legal or constructive obligation to pay those benefits in the future.

5. The individual employer does not have significant influence in the design of the employee benefit plan.

6. The board of a pension plan is legally responsible to provide benefits to the participants in the plan. The responsibility of the sponsoring entities is limited to the payment of contributions to the plan as agreed in a collective labour agreement.

7. In a mandatory collective employee benefit plan the individual employer is not able to significantly influence the policies and decisions of the board since the board consists of representatives of employers' associations and employee unions. The representatives of the employers' associations should act in the interest of the all employers involved in the plan.

Problems in applying IAS 19 to mandatory collective employee benefit plans

8. IAS 19 requires an entity to classify a multi-employer plan as a defined contribution plan or a defined benefit plan under the terms of the plan (including any constructive obligation that goes beyond the formal terms). Where a multi-employer plan is a defined benefit plan, an entity shall:

   (a) account for its proportionate share of the defined benefit obligation, plan assets and cost associated with the plan in the same way as for any other defined benefit plan; and

   (b) disclose information as required by IAS 19.

9. Under IAS 19 mandatory collective employee benefit plans are classified as defined benefit plans due to the fact that the plans are defining benefits (commonly with a benefit formula based on pensionable salaries and conditional indexation rights) while not satisfying the criteria of a defined contribution plan according to IAS 19.

10. Because of the mandatory participation employers consider the premiums that they have to pay to the collective pension fund in the same manner as the premiums levied by the state to execute a general old age state plan. As is the case in state plans, the collective plans are not subject to control or influence by the individual reporting entity (IAS 19.37) while the only obligation of the individual entity is to pay the contributions as they fall due. Like in state plans,

if the entity ceases to employ members of the collective plan, it will have no obligation to pay the benefits earned by its employees in previous years and the entity has no legal or constructive obligation to pay those benefits in the future.

Proposed solution

11. Mandatory collective employee benefit plans should be included in the definition and scope of state plans. This could be achieved by an amendment of IAS 19.36-38. The underlying principle of IAS 19.38 should be redrafted in bold type providing guidance as to when a state plan should be treated as a defined contribution plan.

12. Mandatory collective employee benefit plans should be accounted for as defined contributions plans if the following conditions are satisfied.
    a. Employers are by law or collective (industry wide) labour agreement obliged to participate in collective employee benefit plans;
    b. If an employer cease to employ employees or cease to employ employees that fall under the afore mentioned collective labour agreement or if the employer leaves the collective scheme, it will have no obligation to pay the benefits earned by its employees in previous years and the entity has no legal or constructive obligation to pay those benefits in the future; and,
    c. The individual employer does not have significant influence in the terms and conditions of the collective employee benefit plan.

13. The employer shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from the mandatory collective employee benefit plans. For each separate plan the entity shall disclose:
    a. The relevant terms of the benefit plan;
    b. The relevant elements of the funding agreement (if any) with the pension fund, e.g. fixed contribution arrangements, maximum contributions levels, frequency of resetting pension contributions, predetermined relationships between funding level of pension fund and contribution level of the sponsoring entities;
    c. to the extent that a surplus or deficit in the plan may affect the amount of future contributions;
        i. any available information about that surplus or deficit;
        ii. the basis used to determine that surplus or deficit;
        iii. the implications, if any, for the entity;
    d. The measures that the board of the pension plan might take in case of eventually arising surpluses and deficits within the plan; and,
    e. Anything else deemed relevant considering the pension plan or pension fund.

Basis for Conclusions

14. The individual entities in a collective scheme as described above have had no significant influence in the terms and further design of the pension benefits of their employees. By law or collective labour agreement they had no other choice than to participate in the scheme. Furthermore because of the collective nature of the plan and the further conditions that have been set, the individual entities are not in a position to influence the allocation and funding decisions of the Board of the pension fund or the terms and conditions of the plan itself.

15. In such a collective scheme, the individual employers are not promising pension benefits to their employees; basically they are promising to pay premiums to a collective scheme that operates the collective employee benefit plan. The promise to the plan participants is made by the Board of the plan by way of communicating the relevant pension terms to all the participants involved. In exchange of the services provided by the employees the employer pays the determined premiums to the scheme and promises to continue to do so in the future.

16. The mandatory pension plan could be considered as an extension of the individual reporting entities. By law or collective labour agreement an organisation is established that operates a certain collective employee benefit plan. This plan is basically making the promises to the employees that are covered under the law specification or the collective labour agreement. Responsibilities are divided: the pension fund has a responsibility to properly execute the plan; the sponsoring entities are responsible for paying the premiums. The individual entities are released from their obligation by paying these premiums and they will have no obligation to pay any further amount related to the employee service in previous years if they leave the collective scheme.

17. The obligating event that leads to an obligation is the start of an employer/employee relationship within a certain industry that makes the participation in a scheme compulsory. If the employer leaves the industry without having any legal or constructive obligation or commitment to pay to the scheme for the service of its (former) employees in prior periods, this evidences the fact that the obligating event is not triggered by promising a post employment benefit but by commencing an activity in this particular industry . This approach has similarities with the approach outlined in IFRIC 6 'Liabilities arising from Participation in a Specific Market – Waste Electrical and Electronic Equipment' in which the obligation for the sound disposal of waste equipment is linked to participation in the market during a certain period.

18. A distinction should be made between the present obligation of the collective plan (which is to pay the promised benefits to the retirees) and the present obligation of the sponsoring companies (which is to fund the plan according to the funding decisions made by collective labour agreements or by the Board of the plan).

19. For these reasons, proportioning the assets and liabilities over the contributing entities as required by IAS 19, does not reflect the substance of this collective arrangement.

20. The most appropriate alternative for mandatory collective plans is a defined contribution accounting treatment with detailed disclosures about the position of the fund and the funding arrangements (if any) with the sponsoring employers.

21. Therefore, in our view, enhanced disclosure requirements of the financial position of the pension fund and the possible consequences on the required contribution levels at different scenario's, will provide the user of the financial statements a more faithful representation of the mandatory scheme sponsorship than the current IAS 19 accounting treatment does.

Features of a variable benefit plan

1. Variable benefit plans are pension plans in which the actuarial and investment risk associated with the employee benefit plan are predominantly subscribed by the plan participants (employees, former employees and retirees) and only limitedly by the sponsoring entity. The plan is legally separated from the entity and is administered and governed by an independent body (often a Foundation: from now on described as the pension fund).

2. A variable benefit plan contains a benefit formula that is linked to employees' remuneration and years of service with a benefit formula based on current salaries and conditional indexation rights.

3. A variable benefit plan is funded both by the employer and employee. The employee's component is withheld by the employer from the employee's salary and paid to the fund together with the part the employer is required to pay. The attribution of the employers and employees' part of contribution is subject to periodic labour agreement negotiations.

4. The contribution level payable to the pension fund is part of labour agreement negotiations between employer and employee (the latter represented by unions or work councils) but should *at a minimum* be sufficient cover the costs of future benefits according to the current terms of the plan and measured according to an actuarial valuation method. Employer and employees could agree to reduce the level of future benefits in order to avoid an otherwise necessary contribution level increase.

5. The board of the pension fund is composed of an equal number of representatives from both employers and (former) employees. The board of the pension fund is required by law or by articles of association to act in the interest of the fund and of all relevant stakeholders in the scheme, i.e. active employees, inactive employees, retirees, employers.

6. The pension fund centrally administers the plan assets that are generated by the contributions of the sponsoring employer, and uses these assets only to provide benefits to the participants (formerly) employed by the sponsoring employer.

7. The employer(s) are not able to control, currently or potentially, the pension fund assets and activities because of the fact that the board is equally represented by employers and employees and consensus should be reached on each and every board's decision.

8. The board of the pension fund is responsible for the investment policy with regard to the assets of the fund. Generally, this means that they will give instructions to investment funds to invest and administer the plan assets taking into account specific risk management policies, asset mix allocations and administrative procedures. The ultimate responsibility of the asset mix allocation rests with the board of the pension fund and not with the employer or group of employers contributing to the fund.

9. The board of the pension fund is responsible for a proper execution of the pension terms. Pension terms cover at least the following:

   a. Determination of pension benefits (plan benefit formula; indexation measures) and payment thereof;
   b. Conditions and procedures for individual value transfer; and,
   c. Possible measures to be taken in the case of shortfall in the fund's assets.

10. Typically measures that can be taken from year to year (and notably in case of underfunding) by the board of the pension fund are primarily a foregoing of the indexation of accrued pension entitlements (risk borne by active employees, former employees and retirees) because of the contractual arrangement that indexation can only be granted if the fund has sufficient resources. If after the foregoing of indexations, a shortage still exists compared to a minimum funding level, available measures are:

    a. A reduction of pension entitlements that are earned by the active employees in the current service period (risk borne by active employees);

    b. A reduction of accrued pension entitlements (risk borne by active employees, former employees and retirees);

    c. An increase of contribution levels payable to the fund (risk borne by employer and employees as result of the shared funding system.

11. The board of the pension fund is required by law or by the articles of association to act in the interest of the fund and of all relevant stakeholders in the plan and this includes the consequences of taking the aforementioned measures. Therefore, in a variable benefit plan all stakeholders are exposed to actuarial and investment risk but the risks rest predominantly upon the (former) employees and retirees since the benefits are variable in nature. Due to the conditionality of indexation grants the ultimate benefit to be paid to the retirees is subject to a high degree of variability (even with modest inflation forecasts, subsequent indexation might comprise approximately 70% of the ultimate payment to the retiree).

12. In case of a pension surplus the board of the pension fund decides on the allocation of the surplus among the stakeholders. Because of the fact that the indexation entitlements are conditional (depending on a sufficient level of the fund's assets), the surplus is typically used for the indexation of pension entitlements (beneficiaries are the participants, active and former employees and retirees).

13. In case of termination of the plan or the fund itself, the board of the fund decides on the allocation of the surplus or the deficit amongst the stakeholders, taking into account the requirement to act in the interest of all relevant stakeholders in the scheme.

Problems in applying IAS 19 to variable benefit plans

14. Under IAS 19 variable benefit plans are classified as defined benefit plans due to the fact that the plans are defining a minimum level of benefits while not satisfying the criteria of a defined contribution plan according to IAS 19.

15. IAS 19 makes no distinction between an employer that solely subscribes the actuarial and investment risk (gaining from surpluses and suffering from losses) and employer(s) that only limitedly subscribe(s) these risks with other stakeholders in the plan.

16. From the perspective of employers participating in a variable benefit plan their primary obligation is to pay the agreed contributions to the fund. Paying the required contribution to the pension fund reflects from their perspective a transfer of control over the contributed assets to the board of the pension fund who is legally entitled to take subsequent allocation decisions.

17. A surplus of deficit in the pension fund according to the measurement principles of IAS 19 will not lead by any mechanism to a present obligation of the employer due to variety of reasons. At first, the most important determinant of the pension result for the employee, the post-contribution indexations, are conditional and will only be granted if sufficient assets are available. Secondly, not the IAS 19 measurement method but the local funding requirements are decisive whether or not the fund faces a surplus or a deficit situation. Thirdly, the board of the fund decides how and to which extent the deficits and surpluses should be divided among the stakeholders while the board is required to act in the interests of all stakeholders. At fourth, an increase of the contribution levels could be avoided by the sponsors of the fund, meaning employers and employees, if they agree to reduce the level of benefits in the coming period.

18. IAS 19 requires the sponsoring employer to recognise fully the defined benefit obligation and the plan assets associated with the plan. Based on the previous paragraphs this full recognition of the financial situation of the pension fund based on the IAS 19 measurement principles does not faithfully represent the present obligation of the sponsoring entity.

Proposed solution

19. Variable benefit plans should be accounted for as defined contributions plans if certain conditions are satisfied. These conditions are:

    a. The plan should be administered by an independent entity (pension fund) with a board in which the employer and participants to the plan are at least equally represented and which fully controls the assets and the activities of the plan;

    b. The board of the pension fund should be required by law or by the articles of association to act in the interest of the fund and of all relevant stakeholders in the scheme, i.e. active employees, inactive employees, retirees and employers;

    c. A curtailment, settlement or amendment of the terms of the employee benefit plan must ultimately be approved by the board of the fund and could not be forced unilaterally by one of the stakeholders in the plan;

    d. In case of termination or unwinding of the pension fund the board of the pension fund decides how to allocate the surpluses or deficits among the stakeholders;

    e. In case of pension plan deficits or surpluses towards a legally or statutory required minimum funding level, the board of the pension fund decides how and to which extent the deficits and surpluses should be divided among the stakeholders;

    f. The plan benefit formula should be based on current or career average salaries; indexation of entitlements will only be granted by the pension plan if the plan holds enough resources (indexation is conditional on availability of funds);

    g. The plan should be mutually funded, both by employers and by employees. The funding level should be agreed by both parties. If the agreed funding level is not enough to cover all pension costs under the plan, the Board has a mandate to take adequate measures in order to align the future pensions costs with the agreed funding levels; and,

    h. In any case the funding level should is based on reasonable actuarial assumptions and should in this regard be sufficient to cover all the pension expenses in a determined future period.

20. The sponsoring employer shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from variable benefit plans. For each separate plan the entity shall disclose:

    a. the relevant terms of the benefit plan;

b. the relevant elements of the funding agreement (if any) with the pension fund, e.g. fixed contribution arrangements, maximum contributions levels, frequency of resetting pension contributions, predetermined relationships between funding level of pension fund and contribution level of the sponsoring entity and the actuarial assumptions that are used in setting the yearly or periodic contribution level;

c. to the extent that a surplus or deficit in the plan may affect the amount of future contributions;

   i. any available information about that surplus or deficit;

   ii. the basis used to determine that surplus or deficit;

   iii. the implications, if any, for the entity;

d. The measures that the board of the fund might take in case of eventually arising surpluses and deficits within the plan; and,

e. Anything else deemed relevant considering the pension plan or pension fund.

Basis for Conclusions

21. The accounting requirements of IAS 19 applied in the situation of a variable benefit plan can lead to the recognition of assets that are not controlled and liabilities that are not present obligations of the reporting entity itself. A sponsoring employer to a variable benefit plan is at the most jointly controlling the investments and the activities of the pension fund indirectly through its representatives in the board of the pension fund. The board of the pension fund has a mandate to act in the interest of all participants in the plan and should not to be regarded as an extension of the (group of) reporting entity(ies) that participate in the plan.

22. Taken into account the definition of an asset in the framework it is obvious that the assets of a pension fund could not be regarded as a controlled resource of the participating entity because the entity is not in a position to control or influence the allocation decisions regarding these assets.

23. The pension plan as described above is acting in a fully independent position as a result of which the plan itself should be regarded as the primary obligor of a pension plan deficit. It is the primary responsibility of the pension plan board to take adequate measures in case a pension plan deficit occurs. A complicating factor is that in most jurisdictions pension plan deficits are not measured according to the IAS 19 methodology but according to local minimum funding requirements.

24. The granting of an indexation of build up pension entitlements is an important measure for all participants involved. To illustrate: the pension that ultimately will be paid to the retiree, consists for a majority part of indexations that have been granted in the past. Because of the fact that indexation is conditional and depends on the availability of resources in the plan, it is fair to state that the majority of risks that originates from the benefit promise rest upon the (former) employees and retirees.

25. Even in case of a pension plan deficit after the foregoing of indexation, the board should act in the interest of all parties involved.

26. One of the measures that might be taken in case of a surplus or a deficit situation is a decrease or an increase in contributions levels to be paid to the fund which can be avoided by the sponsoring employer and employees in mutual negotiations as

explained earlier. This mechanism evidences the factor that the plan is co-sponsored by both employer and employees.

27. If agreed funding levels fall below minimum funding requirements according to local regulations, the Board should take measures which often will result in an amendment of the plan benefit formula meaning that the level of benefits in future years will decrease as well. Another possibility in which the entity will not suffer from a deficit situation is that an increase of the contribution level is paid by the employees. In a subsequent opposite situation of a surplus, employees will have negotiated that they will benefit fully from a contribution level decrease.

28. Especially in this co-sponsored and variable benefit situation the relationship between an IAS 19 deficit and a reliably measurable outflow of cash flows from the sponsoring entity is hard to draw due to the various factors described in the previous paragraphs. This raises the question whether, in case of a IAS 19-deficit, the reporting company really has a present obligation since it is not evident at all that the deficit causes a settlement by which the entity should give up resources embodying economic benefits (Framework, par 62). Apart from questions regarding the definition of a liability, recognition problems seem to occur as well, due to the fact that it is unknown whether and to what extent the deficit will lead to a probable and measurable outflow of resources (Framework, par 91).

29. As a result the assets and liabilities related to a variable benefit plan do not meet important elements of the definition and recognition criteria of assets and liabilities in the *Framework* and consequently the corresponding amounts are not a faithful representation of the sponsoring entity's assets and liabilities.

30. The appropriate alternative for variable benefit plans is a defined contribution accounting treatment with detailed and appropriate disclosures about the cash flow risks inherent in the plan as indicated before.

31. In a defined contribution system the pension costs in the financial statements of the employer are equal to the employer's part of the contributions paid to the fund. If the contributions are based on marked based actuarial estimates of the costs of the benefits earned in a period, pension costs will reflect the market value of pension entitlements earned in this period. Therefore, we regard this condition of actuarially determined contributions based on current market conditions as an important prerequisite. Sometimes local regulators will demand an even higher contribution level due to fixed charges for future indexation and solvency purposes. In this case the condition is also met because the contribution should be at least sufficient to cover the expenses.

32. To summarise, if the conditions of variable benefit plans are satisfied, defined contribution accounting accompanied by enhanced disclosure requirements of the financial position of the pension fund and the possible consequences on the required contribution levels at different scenario's, will provide the user of the financial statements more meaningful information with regard to the risk profile of the future funding of the pension fund than the current IAS 19 accounting treatment does.