NAPF Response to IASB Exposure Draft ED/2010/3
'Defined Benefit Plans: Proposed amendments to IAS 19'

Summary

- The NAPF welcomes the IASB's decision not to go ahead with its earlier proposals for Contribution Based promises, as these would represent a fundamental change in pensions accounting that is out of scope in what is intended as an interim amending standard.

- We strongly support the IASB's proposals to simplify presentation in the income statement. In particular, we welcome the proposal to show remeasurements in Other Comprehensive Income as this will prevent the profit and loss account being swamped by market-driven volatility.

- While we see the attractions of the IASB's proposal that pension income (or expense) should be measured by the application of the discount rate on the scheme liabilities to the pension surplus (or deficit), the approach does not reflect the reality of an investment model that, for many schemes, is based on out-performance of risk-seeking assets held for the long term. We suggest that the Board delay introducing the net interest approach until after its fundamental review of pensions accounting. In the meanwhile, pension income should continue to be accounted for on the basis of expected returns.

- We recommend that the IASB hold over decisions on the removal of the current options on taxes and administration costs, and on the role of future salary increases in determining the benefit formula, to its fundamental review of pensions accounting.

1 Introduction – about the NAPF

1.1 The National Association of Pension Funds (NAPF) is the leading voice of workplace pensions in the UK. We speak for 1,200 pension schemes with some 15 million members and assets of around £800 billion. NAPF members also include over 400 businesses providing essential services to the pensions sector.

1.2 As major investors responsible for the pensions of millions of workers, our pension scheme members are looking for accounting for pensions in the sponsor accounts that provides investors and other stakeholders with a realistic assessment of the pension promise and the obligations that it places on the scheme sponsor, taking into account the long-term nature of pension obligations.

1.3 Pension schemes are major investors in equities, both domestic and international, and have significant exposure to corporate bonds; in the UK, for example, they own 13 per cent of the domestic equity market – and considerably more when indirect investment through pooled funds is taken into account. Pension schemes and the investment managers acting on their behalf rely on the quality of companies' financial reporting to inform their investment policies. At the same time, they are very much aware that employers should not be discouraged from offering good quality pensions that are in fact perfectly affordable, for example because the accounting gives rise to an apparent volatility in the accounts that is not a reflection of economic reality.

2 General Comments

2.1 We are grateful for the opportunity to respond to the IASB's Exposure Draft 'Defined Benefit Plans: Proposed amendments to IAS 19'.

2.2 We welcome the Board's decision not to go ahead with its earlier proposals for Contribution Based promises. The proposals represented a fundamental change in pensions accounting and were clearly out of scope in what is intended as an interim amending standard.

2.3 We also welcome the Board's decision not to review how multi-employer schemes are accounted for on the face of the accounts. Accounting for individual employer's liabilities raises a number of fundamental issues which we do not believe can be resolved in what is intended as an interim amending standard: both legal issues as to individual employers' liability (different in different jurisdictions) and practical measurement issues as to how the liability is to be allocated between the employers in the scheme.

2.4 We strongly support the IASB's proposals to simplify presentation in the income statement. In particular, we welcome the proposal to show remeasurements in Other Comprehensive Income as this will prevent the profit and loss account being swamped by market-driven volatility. We cannot emphasise too strongly that pension liabilities do not in reality fluctuate widely from one year to the next, but change gradually over time in line with scheme demographics. We are convinced that an accounting treatment that gives rise to an apparent volatility that in no way reflects economic reality will lead to economically poor decisions on pension provision and to the closure of good quality schemes that could – and should – be kept open.

2.5 While we see the attractions of the IASB's proposal that pension income (or expense) should be measured by the application of the discount rate on the scheme liabilities to the pension surplus (or deficit), the approach does not reflect the reality of an investment model that, for many schemes, is based on out-performance of risk-seeking assets held for the long term. Although simple and pragmatic, the net interest approach could well understate the sponsor's income from the scheme. It also raises questions about what should be the approach if the scheme's investment strategy is unlikely to give a return equal to the discount rate. We therefore suggest that the Board may wish to delay introducing the net interest approach until after its fundamental review of pensions accounting, when these issues can be more fully considered. If the Board decides to postpone the introduction of a net interest approach, we suggest that in the interim the expected return approach be maintained.

2.6 We also feel that the Board underestimates the issues around taxes and administration costs and the role of future salary increases in determining the benefit formula. We recommend that the Board hold over decisions on the removal of the current options to its fundamental review of pensions accounting.

2.7 We comment in some detail in our answers to Questions 9 and 10 on the Board's proposed disclosed disclosures.

3 Answers to specific questions

Recognition

Q1	*The exposure draft proposes that entities should recognise all changes in the present value of the defined benefit obligation and in the fair value of plan assets when they occur (Paragraphs 54, 61 and BC9–BC12). Do you agree? Why or why not?*

We agree that entities should recognise changes in the present value of the defined benefit obligation and in the fair value of plan assets when they occur. We would expect other obligations in the accounts to be treated in the same way.

Q2	*Should entities recognise unvested past service cost when the related plan amendment occurs? (Paragraphs 54, 61 and BC13). Why or why not?*

We agree that unvested past service cost should be recognised when the related plan amendment occurs. We believe that the IASB should consider, for its fundamental review of pensions accounting, the inclusion of a separate pensions statement within the income statement.

Disaggregation

Q3	*Should entities disaggregate defined benefit cost into three components: service cost, finance cost and remeasurements? (Paragraphs 119A and BC14–BC18). Why or why not?*

We agree that defined benefit cost should be disaggregated into three components: service cost, finance cost and remeasurements.

Defining the service cost component

Q4	*Should the service cost component exclude changes in the defined benefit obligation resulting from changes in demographic assumptions? (Paragraphs 7 and BC19–BC23). Why or why not?*

We agree that service cost should exclude changes in the defined benefit obligation resulting from changes in demographic assumptions and that these should instead go through Other Comprehensive Income as remeasurements.

Defining the finance cost component

Q5	*The exposure draft proposes that the finance cost component should comprise net interest on the net defined benefit liability (asset) determined by applying the discount rate specified in paragraph 78 to the net defined benefit liability (asset). As a consequence, it eliminates from IAS 19 the requirement to present an expected return on plan assets in profit or loss.* *Should net interest on the net defined benefit liability (asset) be determined by applying the discount rate specified in paragraph 78 to the net defined benefit liability (asset)? Why or why not? If not, how would you define the finance cost component and why? (Paragraphs 7, 119B, 119C and BC23–BC32).*

We believe the net interest approach has merit because it a) eliminates the need for an expected return assumption, b) logically shows a cost when there is a deficit and a contribution to profit when there is a surplus, and c) recognises that in most territories the liabilities and assets are not directly owned by the reporting entity but are held indirectly through trusts or similar structures.

We believe that there are some issues with a net interest approach that the Board needs to consider. On the one hand, it fails to take into account – and could be seen as actively discouraging – investment strategies on the part of the scheme directed at outperforming the discount rate. Such strategies, which can significantly reduce the cost of pension provision, are entirely appropriate for schemes with a strong sponsor covenant. On the other hand, it raises questions about what should be the approach if the scheme's investment strategy is unlikely to give a return equal to the discount rate. This could happen where the investment return is taxed or where the pension plan has de-risked and invests mainly in low-risk assets. We therefore suggest that the Board may wish to delay introducing the net interest approach until after its fundamental review of pensions accounting, when these issues can be more fully considered. If the Board decides to postpone the introduction of a net interest approach, we suggest that in the interim the expected return approach be maintained.

Presentation

Q6 *Should entities present:*

(a) service cost in profit or loss?

(b) net interest on the net defined benefit liability (asset) as part of finance costs in profit or loss?

(c) remeasurements in other comprehensive income?

(Paragraphs 119A and BC35–BC45). Why or why not?

We agree. If the Board decides to postpone introduction of the net interest approach and remain for the time being with expected returns (see our answer to Question 5), expected returns and interest cost should both be included as part of finance income and cost in the profit and loss account (Question 6 (b)).

Settlements and curtailments

Q7

(a) Do you agree that gains and losses on routine and non-routine settlement are actuarial gains and losses and should therefore be included in the remeasurement component? (Paragraphs 119D and BC47). Why or why not?

(b) Do you agree that curtailments should be treated in the same way as plan amendments, with gains and losses presented in profit or loss? (Paragraphs 98A, 119A(a) and BC48).

(c) Should entities disclose (i) a narrative description of any plan amendments, curtailments and non-routine settlements, and (ii) their effect on the statement of comprehensive income? (Paragraphs 125C(c), 125E, BC49 and BC78). Why or why not?

We agree that:

(a) gains and losses on routine settlements are likely to reflect actuarial gains or losses and should therefore be included in remeasurements. We note that employer-instigated non-routine settlements should perhaps more appropriately be presented in profit and loss, like curtailments and plan amendments; however, it may sometimes be difficult to distinguish between routine and non-routine settlements, which may make it impractical to require entities to distinguish between the two.

(b) curtailments should be treated the same way as plan amendments, with gains and losses presented in profit and loss.

(c) entities should disclose (i) a narrative description of plan amendments, curtailments and non-routine settlements, and (ii) their effect on the statement of comprehensive income. We would emphasise that only material amendments, curtailments and settlements should be disclosed.

Disclosures

Defined benefit plans

Q8	*The exposure draft states that the objectives of disclosing information about an entity's defined benefit plans are:*
(a)	*to explain the characteristics of the entity's defined benefit plans;*
(b)	*to identify and explain the amounts in the entity's financial statements arising from its defined benefit plans; and*
(c)	*to describe how defined benefit plans affect the amount, timing and variability of the entity's future cash flows. (Paragraphs 125A and BC52–BC59).*
	Are these objectives appropriate? Why or why not? If not, how would you amend the objectives and why?

We agree that the objectives listed are appropriate. We agree with the IASB's general approach, which is based on allowing companies scope to use their judgement in deciding on disclosures. We believe that this reflects the reality that the materiality of the scheme differs between companies. Excessive prescription would be burdensome on preparers of accounts and would reduce the usefulness of the information provided by making it more difficult for users to identify important disclosures.

The IASB's approach places a burden of responsibility on companies not to abuse their discretion and on investors and analysts to insist that companies provide the information that they require. We very much hope that companies, investors and analysts will live up to their responsibilities.

We comment in more detail in our answer to Question 9 on the individual disclosures proposed, which we feel should not be too burdensome on companies. We also propose a number of additional disclosures that would assist users of financial statements.

Q9 *To achieve the disclosure objectives, the exposure draft proposes new disclosure requirements, including:*

(a) information about risk, including sensitivity analyses (paragraphs 125C(b), 125I, BC60(a), BC62(a) and BC63–BC66);

(b) information about the process used to determine demographic actuarial assumptions (paragraphs 125G(b) and BC60(d) and (e));

(c) the present value of the defined benefit obligation, modified to exclude the effect of projected salary growth (paragraphs 125H and BC60(f));

(d) information about asset-liability matching strategies (paragraphs 125J and BC62(b)); and

(e) information about factors that could cause contributions to differ from service cost (paragraphs 125K and BC62(c)).

Are the proposed new disclosure requirements appropriate? Why or why not? If not, what disclosures do you propose to achieve the disclosure objectives?

Our comments on the new disclosures proposed are as follows:

(a) *information about risk*. We recognise the desire of many users of accounts for greater sensitivity analysis on risk. Investors and analysts need information on which they can form an assessment of the company's prospects. We are particularly concerned about paragraph 125I, which we fear might place an excessive burden on the company without providing information whose value is proportionate to the effort in producing it. The wording of 125I (a) is both unclear and insufficiently specific to provide comparable information for different companies. We also believe that the relevant reporting criterion is significance at the end of the reporting period both for the defined benefit obligation and for service costs going forward.

(b) *process to determine demographic actuarial assumptions*. We agree with the approach proposed which would allow companies to use their judgement in determining which assumptions they should disclose.

We agree that, in view of the different circumstances of individual companies, it would not be helpful to be too prescriptive. We also agree with an approach that would allow companies to refer to standard mortality tables (for example) without having to produce an excessive amount of detail.

(c) *defined benefit obligation excluding salary increases.* We believe that this is a useful disclosure which would be easy for companies to provide.

(d) *information about asset liability matching strategies.* Again, we believe that this is a useful disclosure which should not be too difficult for companies to provide.

(e) *information about factors that could cause contributions to differ from service cost.* We query whether this is a useful disclosure, as there is no reason why contributions should match service cost. However, companies should be obliged to provide separately and in greater detail information on commitments to which they are contractually obliged, for example agreed recovery programmes to put right scheme deficits (see our comments immediately below). Disclosures on recovery programmes should cover the complete programme, however long or short it is, and not just the first five years.

We believe that analysts and investors and the agents who invest on their behalf (investment managers) are particularly interested in the cash payments that the sponsor is bound by law or agreement to make into the fund. To be useful, such disclosures need to be detailed, not aggregated. Analysts use this information to model future free cash flow and as a basis for estimating a 'cash funding liability'. Such disclosures are incomplete without information on the assumed investment returns (or similar variables that justify the repayment schedule) and on the risk that the schedule might change.

Analysts and investors would also like information on duration and a time analysis of liabilities. These tell a different – although related – story and both would be useful. A disclosed (mathematical) duration in years would provide a quick and simple reference point for comparing pension liabilities; it would also provide more insight into potential sensitivities to changes in interest rates and inflation. Numerical disclosures of estimated pension payments by (say) 5-year time buckets obviously gives far more insight into the length of time required to run off the liability – while the average duration of UK schemes is around fifteen years, the run-off is many decades. Numerical disclosures can also be usefully combined with a cash flow chart to provide a powerful graphical representation of pension commitments.

Both approaches help to convey the fact that while the liability may be large, annual cash payouts are much smaller. Disclosing the expected pension payments also enables analysts to estimate (in a crude fashion) the extent to which the pension assets provide matching inflows, thus offering a greater insight into the investment risks being taken or hedged.

It should not be too difficult for companies to provide the information – the best already do.

Multi-employer plans

Q10	*The exposure draft proposes additional disclosures about participation in multi-employer plans. Should the Board add to, amend or delete these requirements? (Paragraphs 33A and BC67–BC69) Why or why not?*

Our comments on the individual disclosures proposed in paragraph 33A are as follows:

(a) we agree that the entity should provide a description of the funding arrangements, including the method used to determine the entity's rate of contributions and any minimum funding requirements.

(b) we agree that the entity should disclose the extent to which it can be liable to the plan for other entities' obligations under the terms and conditions of the multi-employer plan.

(c) we agree that the entity should disclose the total number of active, retired and former members entitled to benefits, and the entity's proportion of that total, if the information is available. We see this as a means of enabling users of employer accounts to get a rough idea of the potential magnitude of the entity's share of any surplus or deficit.

(d) the proposed requirement to disclose details of any agreed deficit or surplus allocation on wind-up of the plan, or the amount that is required to be paid on withdrawal of the entity from the plan, needs clarification. It should be made clear that "amount" refers to a description of how the amount would be arrived at. We do not believe that it is feasible for the scheme, which would presumably have to provide the information to participating employers, to provide a wind up figure for each employer. It would, however, be appropriate for an entity to disclose the actual amount to be paid as a contingent liability if its withdrawal from the plan was under consideration or likely.

(e) we agree that, where the entity accounts for its proportionate share of the defined benefit obligation, plan assets and cost associated with the plan in accordance with paragraph 29A, it should disclose all the information required by paragraphs 125A–125K for that proportionate share.

(f) we agree that, where the entity accounts for the plan as if it were a defined contribution plan in accordance with paragraph 30, it should disclose:

(i) the fact that the plan is a defined benefit plan;

(ii) the reason why sufficient information is not available to enable the entity to account for the plan as a defined benefit plan; and

(iv) where available, information about any deficit or surplus in the plan that may affect the amount of future contributions, including the basis used to determine that deficit or surplus and the implications, if any, for the entity. The funding level and monetary amount of any surplus or deficit should both be disclosed.

On (f) (iii) (the expected contributions to the plan for the next five annual reporting periods, and a description of the contractual agreement or other basis used to determine the expected contributions), we query the usefulness of requiring the disclosure of monetary amounts, which would necessarily be dependent on uncertain assumptions. Employers might also feel that disclosure of monetary amounts could be commercially sensitive or undermine their negotiating position in wage negotiations. We agree that employers should disclose expected contribution rates.

Q11	*The exposure draft updates, without further reconsideration, the disclosure requirements for entities that participate in state plans or defined benefit plans that share risks between various entities under common control to make them consistent with the disclosures in paragraphs 125A–125K. Should the Board add to, amend or delete these requirements? (Paragraphs 34B, 36, 38 and BC70). Why or why not?*

We agree that this is not the time to reconsider the disclosure requirements for the state plans and plans sharing risks under common control beyond updating them for consistency. A lower level of disclosure may be sufficient for small unlisted subsidiaries.

Other comments

Q12	*Do you have any other comments about the proposed disclosure requirements? (Paragraphs 125A–125K and BC50–BC70).*

No further comments.

Other issues

Q13	*The exposure draft also proposes to amend IAS 19 as summarised below:*
(a)	*The requirements in IFRIC 14 IAS 19—The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction, as amended in November 2009, are incorporated without substantive change (Paragraphs 115A–115K and BC73).*
(b)	*'Minimum funding requirement' is defined as any enforceable requirement for the entity to make contributions to fund a post-employment or other long-term defined benefit plan (Paragraphs 7 and BC80).*
(c)	*Tax payable by the plan shall be included in the return on plan assets or in the measurement of the defined benefit obligation, depending on the nature of the tax (Paragraphs 7, 73(b), BC82 and BC83).*
(d)	*The return on plan assets shall be reduced by administration costs only if those costs relate to managing plan assets (Paragraphs 7, 73(b), BC82 and BC84–BC86).*
(e)	*Expected future salary increases shall be considered in determining whether a benefit formula expressed in terms of current salary allocates a materially higher level of benefits in later years (Paragraphs 71A and BC87–BC90).*
(f)	*The mortality assumptions used to determine the defined benefit obligation are current estimates of the expected mortality rates of plan members, both during and after employment (Paragraphs 73(a)(i) and BC91).*
(g)	*Risk-sharing and conditional indexation features shall be considered in determining the best estimate of the defined benefit obligation (Paragraphs 64A, 85(c) and BC92–BC96).*
	Do you agree with the proposed amendments? Why or why not? If not, what alternative(s) do you propose and why?

(a) We agree that the requirements in IFRIC 14 should be incorporated without substantive change.

(b) We are comfortable with the proposed definition of 'minimum funding requirement'.

(c) & (d) We believe that the issues around taxes and administration costs in relation to past service are not as straightforward as the Board suggests.

Similar considerations apply to levy payments, for example (in the UK) for the Pension Protection Fund. In particular, the Exposure Draft's proposals are inconsistent with the accounting treatment for DB pensions and could artificially affect choices between DB and DC pension provision. We do not believe that this is a matter that needs to be urgently addressed. Because of this, and the fact that there are different views on the appropriate treatment of taxes and administration costs that deserve fuller consideration, we recommend that decisions on the removal of the current options should be held over to the IASB's fundamental review of pensions accounting.

(e) The removal of the options in respect of the use of future salary increases in determining whether a benefit formula allocates a materially higher level of benefits in later years raises measurement issues that we do not believe are within the scope of the Exposure Draft. The proposal would also require an inconsistent treatment of career average and DC schemes that could artificially affect decisions on the form of pension provision. As with taxes and administration costs (Question 13 (c) and (d)), we recommend that decisions on the removal of the current options should be held over to the IASB's fundamental review of pensions accounting. Furthermore, as we argued in our response to the Board's earlier Discussion Paper on amendments to IAS 19, we do not accept that future salary increases are an obligation on the employer.

(f) We agree that mortality assumptions should be current estimates of expected mortality rates of plan members.

(g) We agree that risk sharing and conditional indexation features should be considered in determining the best estimate of the defined benefit obligation.

Multi-employer plans

Q14	*IAS 19 requires entities to account for a defined benefit multi-employer plan as a defined contribution plan if it exposes the participating entities to actuarial risks associated with the current and former employees of other entities, with the result that there is no consistent and reliable basis for allocating the obligation, plan assets and cost to individual entities participating in the plan. In the Board's view, this would apply to many plans that meet the definition of a defined benefit multiemployer plan. (Paragraphs 32(a) and BC75(b)).* *Please describe any situations in which a defined benefit multi-employer plan has a consistent and reliable basis for allocating the obligation, plan assets and cost to the individual entities participating in the plan. Should participants in such multi-employer plans apply defined benefit accounting? Why or why not?*

We find it difficult to envisage, in the context of UK schemes, the circumstances in which a participant in a DB multi-employer plan that exposes the participating entities to actuarial risks associated with the current and former employees of other entities would be able to account for its share of the pension obligation on a consistent and reliable basis.

Transition

Q15	*Should entities apply the proposed amendments retrospectively? (Paragraphs 162 and BC97–BC101). Why or why not?*

We agree that entities should apply the proposed amendments retrospectively, as it would make no sense to include figures on an inconsistent basis within the same set of accounts. We note that entities will not have to recalculate amounts for dates earlier than the first period presented in the financial statements and believe that the requirement should not be too onerous for companies.

Benefits and costs

Q16	*In the Board's assessment:*
(a)	*the main benefits of the proposals are:*
(i)	*reporting changes in the carrying amount of defined benefit obligations and changes in the fair value of plan assets in a more understandable way.*
(ii)	*eliminating some presentation options currently allowed by IAS 19, thus improving comparability.*
(iii)	*clarifying requirements that have resulted in diverse practices.*
(iv)	*improving information about the risks arising from an entity's involvement in defined benefit plans.*
(b)	*the costs of the proposal should be minimal, because entities are already required to obtain much of the information required to apply the proposed amendments when they apply the existing version of IAS 19.*
	Do you agree with the Board's assessment? (Paragraphs BC103–BC107) Why or why not?

We do not fully accept the Board's assessment of the proposed benefits of the Exposure Draft's proposals. In particular, we believe that the removal of the options in relation to tax and administration costs and to the use of expected salary increases in determining whether a benefit formula allocates a higher level of benefits in later years could encourage non-economic decisions on pension choices (see our answers to Question 13 (c)–(e)).

Otherwise we are in general agreement with the Board's assessment. We do not believe that the proposals will be excessively onerous for preparers of accounts.