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Le Président

JFL/PhS

N°406

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Mr. Stig Enevoldsen

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Re :The Financial Reporting of Pensions

Dear Ian

I am pleased to provide you with the CNC's comments on the above-mentioned PAAinE discussion paper (DP) which are set out in detail in the Appendix.

The DP is a stimulating contribution to the current debate on the financial reporting of pensions and contains a number of innovative features compared to IAS 19, some of which we would like to comment on.

The DP proposes a consistent principle for recognising pension liabilities and attributing benefits to periods of service: the present obligation, which may be of a legal or constructive nature. This contrasts with the view in IAS 19 which is based on expected future salaries and spreads pension costs over employees' service lives.

However, many of our constituents are uneasy about moving away from an approach they believe better reflects expected future cash outflows. In particular, they believe the concept of a "constructive obligation" should include the economic obligation that an employer has to increase its workforce's salaries in the future, which is a broader concept than that developed in the DP.

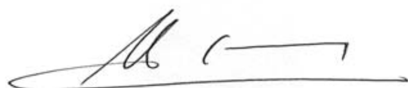
The DP proposes an important change compared to the existing requirements of IAS 19 in that it would apply a "risk-free" rate for discounting pension liabilities. However, we did not find the arguments in the DP sufficiently convincing to justify a change in current practice. As a result we would prefer to maintain for the time being the current requirements of IAS 19.

The DP also proposes the elimination of deferral mechanisms (the “corridor”) and the immediate recognition of actuarial gains and losses in the income statement. In the same line of thinking, investment income from assets would be recognised on an actual basis in the income statement and no longer according to the expected rate of return. We well understand the arguments in favour of this approach but nevertheless have certain reservations. We think that these proposals raise the broader issue of performance reporting. Many constituents are concerned that the proposals may provide less relevant user information than under the current standard.

We presume that the disclosure proposals contained in the DP replace and are not additional to the requirements of IAS 19. The DP proposes some useful information in the notes in the form of sensitivity analysis for the main actuarial assumptions. However, there are other proposals, such as providing an alternative calculation of pension liabilities which may prove confusing to users. As the amount of information required by the DP is considerable an appropriate cost/benefit analysis is necessary.

We hope you find these comments useful and would be pleased to provide any further information you might require.

Yours sincerely,



Jean-François Lepetit

APPENDIX

The Financial Reporting of Pensions

A PAAinE discussion paper

Q 1 – Should a liability to pay benefits that is recognised be based on expectations of employees' pensionable salaries when thy leave service, or on current salaries (including non-discretionary increases)?

CNC's reply

1.1. We agree with the principle set out in Chapter 2 of the discussion paper that a liability to pay benefits should be recognised exclusively on the basis of an employer's present obligations.

1.2. The employer's present obligation includes current salary and those future salary increases that are contractually guaranteed at the reporting date.

1.3. The employer's present obligation may also include a "constructive" component .The definition of a constructive obligation, which is currently under review by the Board, is open to interpretation .The components of future salary that result from a present constructive obligation are therefore subject to interpretation and judgment e.g. to what extent is an employer committed by past salary policy or the operation of market forces to give employees salary increases in the future?

1.4. We consider that an employer is committed to giving future increases, whether those increases are contractually guaranteed or not, and that the only open question is "how much". We therefore believe that the employer's present obligation should reflect the best estimate of future salaries to which the employer is in practice committed.

1.5. In our view the concept of a constructive obligation should encompass "economic compulsion" .Under this view, all of the economically unavoidable increases would be included.

Q2 – Should financial reporting be based on the premise that a liability is owed to an individual employee or to the workforce as a whole? What consequences do you consider your view has for recognition and measurement of pension obligations?

CNC's reply

2.1. An employer's present obligation is towards individual employees with which it has a contractual relationship. The existence of the employer's obligation will not be affected by whether we consider individual employees or the workforce as the "unit of account"i.e. we do not believe the unit of account is a recognition issue.

2.2. The underlying issue dealt with in the discussion paper is whether the "unit of account" affects the employer's obligation with respect to future salary increases. The discussion paper considers that an employer might have a constructive obligation to the workforce as a whole because it would not be possible to avoid

future salary increases in an on-going business. The discussion paper suggests that this is less true for an individual employee. We support the idea that economic compulsion may give rise to a constructive obligation and think this is true whether we consider an individual employee or the workforce as a whole.

2.3. The workforce as a whole, or staff categories such as age groups, appear a more relevant and reliable basis for measuring an employer's liability. For example, it may be more relevant to consider categories such as age groups in measuring the employer's liability e.g. employees in the last years of their career will probably be less likely to receive salary increases.

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

CNC's reply

3.1. We agree that recognition should be based only on present obligations although our understanding of what constitutes a present obligation is rather different to the concept set out in the discussion paper.

3.2. Nevertheless, as stated in our reply to Q.1., there is some uncertainty as to what a present obligation includes because the "constructive obligation" component is open to interpretation .As stated in 1.5. above, we do not believe that the concept should be limited to obligations of a purely legal nature since economic obligations which condition an entity's capacity to carry on business are equally unavoidable.

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?

CNC's reply

4.1. We agree that in general terms there appears to be no conceptual justification for applying different principles in determining whether consolidation is appropriate for pension plans.

4.2. However, we believe that the way in which control is assessed may raise specific issues such as the substance of the relationship and the power-sharing between the employer, the members' representatives and the pension plan .Specific guidance on how to assess control with respect to pension plans is required.

4.3. Furthermore, we note that consolidation leads to separate recognition of pension assets and liabilities which represents a loss of information with regard to the financial position of the pension scheme

4.4. We also question how the principle of asset ceilings would apply in these circumstances.

Q5 – Do you agree that the changes in assets and liabilities relating to pension plans should be recognised immediately, rather than deferred and recognised over a number of accounting periods or left unrecognised provided that they are within certain limits (a "corridor") approach ?

CNC's reply

5.1. We agree with the immediate recognition of changes in assets and liabilities.

5.2. However, we do not agree that all changes in assets and liabilities should be dealt with immediately through the income statement.

5.3. In particular, we are in favour of actuarial gains and losses, which include estimation changes that are not part of the result of the reporting period, being dealt with outside the income statement. These gains and losses should be subsequently recycled into income.

5.4. In our view the treatment of these estimation changes raises broader issues of performance measurement and the presentation of financial statements which should be dealt with in the relevant IASB projects and applied to accounting for pensions.

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?

CNC's reply:

6.1. We agree

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

CNC's reply

6.2. We agree that the discount rate should reflect the time value of money and not the actuarial or investment risk .However, the CNC is not totally convinced by the DP's arguments in favour of a risk free rate .Therefore we do not see sufficient grounds for changing the current requirements of IAS 19 as supported by the arguments set out in BC 31 of IAS 19. IAS 19 prescribes the use of "market yields at the end of the reporting period on high quality corporate bonds" or, where no deep market exists, of yields on government bonds.

Information about the riskiness of a liability (i.e. the risk that the amount of pension benefits will differ from today's expectations) is best conveyed by disclosure rather than adjusting the amount of the reported liability?

CNC's reply

6.3. We agree that information about the riskiness of a liability is best conveyed in the form of sensitivity studies in the notes .Adjusting the reported liability leads to arbitrary measurement which is less relevant and reliable for users.

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

CNC's reply

6.4. We agree with the arguments set out in the discussion paper Chapter 5 §7.10. against reducing the amount of the liability to reflect the entity's own credit risk.

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

CNC's reply

6.5. We agree but see practical difficulties in identifying the costs relating to the present pension obligation where the fund administers both the assets and liabilities of the scheme.

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?

CNC's reply

7.1. We agree with the liability being reported at an amount that reflects the probability of different outcomes on the grounds that this better reflects expected future cash outflows and is therefore the most relevant information for users.

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

CNC's reply

8.1. We agree that assets held to pay benefits should be reported at current values.

8.2. If pension liabilities are reported at current value it appears more consistent to report the corresponding pension assets on an equivalent basis.

8.3. Current values appear more relevant and decision-useful to users.

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?

CNC's reply

9.1. We understand that the "net asset or liability" presentation in the employer's accounts reflects the situation where a trust or similar entity has the liability to pay benefits and the employer has the obligation to support the trust (Chapter 7 §4).

9.2. Two views on this question are examined in Chapter7 §4.3. To §4.11. : (a) the first view (§4.3.) is that the employer's net interest should be measured by reference to its obligations to pay contributions ("a contribution-based view") and (b) the view that an employer's net interest should be measured as the difference between the underlying assets and liabilities ("underlying asset and liability view") as if they were held directly by the employer.

9.3.The arguments in favour of the "contribution-based view" set out in §4.6.indicate that it reflects better the way benefits are expected to be funded out of future cash flows .However ,this view is criticised in 4.7.because it relies on assumptions about future returns on investments.

9.4. The "underlying asset and liability view", as stated in 4.6., can be criticised for showing artificial deficits where expected return on assets is higher than the discount rate applied to liabilities.

9.5. The discussion paper concludes in favour of the "underlying asset and liability view".

9.6.We are not convinced that the arguments in favour of the "underlying asset and liability view" in the discussion paper are decisive .We understand it to be a more prudent view : it implicitly assumes that the return on investment will not exceed the discount rate of liabilities .It also ignores all the parameters which might make

the employer's cash obligation lower than that reported e.g. increases in employee contributions, reductions in benefits etc. because the trustees would ensure that benefits can be funded.

9.7. Therefore, whilst we have some support for the prudence of the "underlying asset and liability view" we would be in favour of carrying out further research on the" contribution-based view".

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

CNC's reply

10.1. As stated in our response to Q.5 we are in favour of dealing with actuarial gains and losses outside of the income statement .Having said this, for items dealt with through the income statement, we agree that a separate presentation of the different components of changes in liabilities or assets can provide useful, relevant information to users.

10.2. A separate presentation of "operating" and "financial" items appears relevant .We do however have reservations about the proposals of the discussion paper in respect of items presented under "other financial performance".

10.3. According to the proposals in the discussion paper, actuarial gains and losses include essentially if not exclusively changes in accounting estimates (mortality, staff turnover etc) affecting service cost (see S32 of summary).The discussion paper proposes presenting these gains and losses outside of operating activities in "other financial performance" whereas service cost is, we believe rightly, included in operating result .This treatment does not appear consistent.

10.4. The argument given in §7.18. for excluding actuarial gains and losses from the operating result is their lack of "predictive value" .Whilst we are sympathetic to the objective of making the operational result as predictive as possible, we do not see any fundamental difference between actuarial gains and losses and other changes in accounting estimate which may currently be included in operating result and disclosed according to the requirements of IAS 8.

10.5. In the absence of an IFRS definition of operating result, we consider that changes in accounting estimate relating to service cost should be treated like any other changes of accounting estimate affecting operating costs i.e. it would be more consistent for them to be included in service cost and disclosed in the notes.

10.6. We note that the discussion paper does not specify how the effect of asset ceilings will be represented.

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?

CNC's reply

11.1. The actual return reflects short term fluctuations which have little relevance for the long-term funding of a scheme and introduce volatility into reported performance .Consistent with our position on actuarial gains and losses expressed in answer to Q.5, we do not believe that the actual return on assets is the most relevant information for users. Furthermore , there is the risk that when

performance reflects short-term results this may have an adverse influence on investment policies i.e. whereas equities are often considered to be the highest yield investments in the long term they may not be so over a shorter period .It could be argued that fund managers will therefore be under pressure to reduce their investment in equity to improve short-term performance even if they believe this is not in the long term interest of the scheme .We therefore believe that performance should be measured by reference to the expected return with disclosure of the actual return.

11.2.The CNC is aware of the criticism levelled at the "expected return" because of its supposed arbitrary nature .The CNC would ,therefore be in favour of further research in order to provide guidance with a view to making "the expected return" more transparent and consistent.

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?

CNC's reply

12.1. We are in broad agreement with the objectives summarised in S36 .However, we find them ambitious and are concerned that they might give rise to an excessive amount of information **.**We presume that the proposed disclosures replace and are not additional to current IAS 19 requirements .Overall, we believe that the proposed information is relevant .However, this does not exclude the need for a cost/benefit analysis.

12.2. We consider that sensitivity analysis to show the effect of changes in the principal assumptions for measurement of a pension liability will provide useful information (Appendix A point 4) However; we have doubts about the alternative proposal to provide "value at risk" analysis which we consider complex and less relevant.

12.3. We suggest that providing alternative measures of pension liabilities (Appendix A point 5) is likely to be confusing to users and difficult to justify in cost benefit terms.

12.4. The pension liability details split between active employees, deferred members and pensioners (a new requirement) may prove burdensome for some employers (Appendix A point 8).

12.5. The CNC considers that the projected cash flows from which the present value of liabilities is calculated is not relevant .Instead the relevant information in our view is the cash flow projection used to calculate the contributions which will give rise to cash outflows for the employer. (Appendix A point 9)

12.6. We are concerned that Appendix A point 12 relating to disclosures of risks for financial instruments held could lead to very detailed information that would be burdensome to produce e.g. sensitivity analysis or value at risk analysis for each type of risk to which a defined benefit scheme is exposed .Some members thought that the structure of the portfolio was sufficient information.

Q13 – Do you agree that a multi-employer plan 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?

CNC's reply

13.1. We agree on conceptual grounds that a multi-employer plan should be reflected in an employer's financial statements using the same principles as those that apply to a single employer plan .However, there are practical and regulatory considerations prevalent in different jurisdictions, such as the availability of proportionate asset or liability information and funding requirements, which may influence the way in which this principle can be applied.

13.2. The discussion paper considers three alternative approaches as a surrogate for a settlement amount in determining the employer's liability:

-proportionate share of collective pension asset or liability

-reflect only the effect of recovery plans or asset refund plans

-do not account for the employer's rights and obligations in respect of under- or over –funding.

13.3. We consider that the three alternatives reflect the different circumstances which may be encountered in different jurisdictions and provide a possible application hierarchy according to the availability of the information.

Q14 – Do you agree that a pension plan's general purpose financial report should include its liabilities to pay benefits in the future? Do you agree that the plan's liabilities for futures benefits should be quantified using the same principles as an employer's liability?

CNC's reply

14.1.We can see no conceptual reason for excluding liabilities to pay benefits in the future from a pension plan's financial statements where the pension fund rather than the employer actually has the responsibility for the pension obligation .Without this information the plan's financial statements would not present fairly its financial position.

14.2.We can also see no reason why the liability should be measured according to principles different to those applicable to an employer .As an exception ,we would , however , point out that in some jurisdictions the plan may be entitled to limit its liability to the amount of its available resources.

Q15 – Do you agree that a pension plan's statement of financial position should reflect an asset in respect of amounts potentially receivable under an employer's covenant, and that this should be reflect the employer's credit risk ?

CNC's reply

15.1. We agree that a pension plan's statement of financial position should reflect amounts receivable under an employer's covenant.

15.2. Where there is an actual risk of non-payment the amount receivable should be stated at its recoverable amount taking into account the credit risk of the employer.

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

CNC's reply

16.1. It is not clear how the "settlement amount" concept is applied to contribution based schemes with a guaranteed return.

16.2. The discussion paper does not address the accounting issues raised by national "pay as you go" schemes where employers are only liable to pay contributions.

16.3. The discussion paper does not deal with the issue of deferred contributions falling due after the service period (see IAS 19§45) in a defined contribution plan.

Q17 – Are there further specific issues relating to the cost and benefit of the proposals that should be taken account of in their further development?

CNC's reply

17.1. We suggest that a cost benefit analysis should be carried out for the proposed disclosure requirements (see our response to Q.12.).