Andrea Pryde  
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International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH

Dear Ms. Pryde,

Exposure Draft “Defined Benefit Plans: Proposed Amendment to IAS 19”

I am writing this letter in my personal capacity and as the lead author on a project at the Center for Excellence in Accounting and Security Analysis (CEASA) at Columbia Business School. The views in my comments are consistent with the views that will be presented in the CEASA paper.

As further background for those staff and Board members who do not know, I was the head of the Global Valuation and Accounting group in Equity Research at Morgan Stanley from 1997 through 2005. I became a Vice Chairman and Director of Special Projects for the firm through September 2008. During my time in Equity Research I wrote extensively on the pension and other post-employment benefit obligations of entities and the impact on their financial positions and income of the accounting and economic environment. In all my roles, I also advised investors, corporations and pension fund managers on the topic. As a long-time member of the IASB’s former Standards Advisory Councils, I urged the Board to amend IAS 19 for many years, so I am happy to see that this project is moving forward in the correct direction, from the perspective of all stakeholders who value transparency about the underlying economic activities of entities.

One overall caveat to my comments is that I believe the measurement issues that remain to be tackled by you complicate the debate about your proposal. The core problem is that the degree of uncertainty about the obligation and the asset values for any funded plans, means that any precise measurement is an oxymoron. You have tried to deal with this in an elegant way in your proposal but the measurement issues remain at the heart of obtaining an understanding of the risks to the corporation and all its stakeholders.

Specific responses to the exposure draft follow. As always, I am happy to provide any additional comments if there is any interest.

Yours sincerely,

Trevor S. Harris  
*The Arthur J. Samberg Professor of Professional Practice, and Co-Director, Center for Excellence in Accounting and Security Analysis*
Recognition

Question 1

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?

I agree with this proposal as long as the changes are not summarized in a single measure. Investors, managers and employees/retirees need to recognize and not obfuscate the factors which cause the obligation to fluctuate and the assets to change in value. The various stakeholders can choose what “weights” to assign to the components of the changes, but “hiding” them by not recognizing can only lead to opacity, mispricing, and, I would argue, has led us to the significant exposures to deficits and risks that many entities face today.

Question 2

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

Given the answer to question 1, I clearly believe that unvested prior service cost amendments must be recognized. However, there is some question of whether this adjustment should all be reported in operating costs given the treatment of any net defined benefit assets and remeasurements. Specifically, if an entity has a large surplus, one way in which owners can “recover” the surplus is through increasing the amount of future benefits. From an owner’s perspective this can be economically efficient. But as I understand your proposal, restricted surpluses cannot be recognized and the “use” of this through plan amendments leading to prior service costs will mean a “cost” to the owner that does not reflect economic reality.

Disaggregation

Question 3

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

I believe that the costs should be split into service cost, interest cost on the obligation, return on plan assets, and actuarial remeasurements.

The proposed method of using the discount rate on the obligation for the net obligation or asset is an interesting compromise for proponents of smoothing or a corridor approach. The objective of facilitating the time value components of the change in both the obligation and asset is laudable, but I believe you have created a potential to distort the economic reality. For example, it is conceivable that a company could invest in a high coupon long maturity investment that provides the necessary cash flows to match the actual cash obligation (in the absence of actuarial adjustments). Essentially, this would be an in-substance defeasance. In your approach, I believe that a portion of the coupon would be a remeasurement and you would have volatility in the net benefit or surplus that is not real. By providing the four components and highlighting the components of the asset returns (realized vs. unrealized) you provide a more appropriate reflection of reality. In addition, this prevents future criticism of treating defined benefit plan assets differently from other “securities”.

Trevor S. Harris
Defining the service cost component
Question 4
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?

It is understandable why you would choose to have the service costs exclude the changes in the obligation from changes in the demographic assumptions. However, it is not clear to me why you believe that the changes in the obligations resulting from demographic assumptions are economically different from prior service cost adjustments, at least in so far as they impact current active employees. So I recommend that to the extent there is a “prior service cost component” resulting from the change in obligation due to new demographic assumptions, then that portion should be included with other prior service costs. In addition, to the extent the IASB’s argument is based on predicting future service costs, the future cost is impacted by changes in demographic assumptions (and other changes in plans) so the impact of these “changes” should be indicated in disclosures.

Defining the finance cost component
Question 5
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)

I agree that finance cost should be shown separately, as I have advocated since the late 1990s in my own writings. I also agree that using an expected return on the plan assets is inappropriate. So the use of the discount rate on the obligation for the “expected” asset return is an “elegant” compromise and may be necessary until the more comprehensive review of defined benefits is completed. My concern, expressed in my response to Question 1, is that to suggest that returns on plan assets that are different to a bond discount rate are all from remeasurement is not appropriate and can be quite misleading. All stakeholders should try to understand how an entity is matching the expected cash inflows and outflows for defined benefits. So I would prefer to see a total return on plan assets reported separately from the interest cost and separated between realized and unrealized. A test, I believe you should apply in assessing your approach, is whether a fully defeased plan with a return profile different to the discount rate in IAS 19 would have no additional financing or remeasurement costs or benefits reflected under the proposed treatment. If this is not the case, then I believe your proposal should be amended to ensure that is does.

Presentation
Question 6
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?

I agree with the proposals, subject to my concerns expressed in the answers to questions 1 and 5. It is especially important to remove the finance costs and return on plan assets from operating items in the profit and loss. I acknowledge the discussion in BC 45 on recycling but it makes me even more concerned about not reflecting the actual return on plan assets in the non-operating part of profit and loss.
Disclosures
Defined benefit plans
Question 8
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?

These objectives are appropriate but incomplete. Most managers and investors are also concerned about the amount, timing and variability of earnings (profit and loss). If this were not the case you would not need to separate the components described in question 6. Moreover, predicting future obligations and potentially surpluses and deficits is not independent of the cash flow objective but, in my view merits separate mention, and is arguably a critical input to the cash flow.

Question 9
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?

In general, I agree with these disclosures which will enhance users’ ability to achieve the stated objectives. However, I have some specific recommendations on this topic.
The risk disclosures associated with actuarial assumptions are critical, but there should be more information about the bases for the assumptions made. For example, on demographics, companies should disclose: (1) what table or analysis they used. In the U.S. for many years companies chose an outdated (by more than a decade) demographic estimate because this was the same table used by regulators, despite there being recent updates that would have substantially increased the benefit obligation; (2) historical comparison of their assumptions with actual company data on demographics.

There is too much emphasis on the obligations and not enough on the assets. I do not agree with conclusions in BC60 (c). It is impossible to predict future cash flows (and net deficit/surplus or earnings) without understanding the investment profile of the assets and how these change over time. This is also necessary to be able to address (d) and (e). I am actually puzzled as to how an entity could meaningfully address these requirements without describing its investment profile and strategy.
Multi-employer plans

Question 10

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?

The additional disclosures proposed in paragraph 33A are important improvements for users but I would not allow for the exclusion permitted under paragraph 30. How can a company have this commitment and not know what it owes for at least its employees? If this is the case this should be highlighted as it is a potential risk to all stakeholders.

State plans and defined benefit plans that share risks between various entities under common control

Question 11

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?

I agree with this for the reasons you describe.

Other comments

Question 12

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

Given the measurement issues that will remain, a summary of the projected cash payments into the future for defined benefits, separated into retirees and actives, and a summary of the projected contributions and receipts (from the assets, coupons, dividends, realized returns) will provide the optimal disclosure, and identify how well the asset-liability matching is in place.

I am confused by the statement made in BC53, which seems gratuitous. “Excessive detail” is nebulous and is too easily used to limit useful disclosures. I believe that knowledge of the investment profile and philosophy for investing plan assets is far more important than the actuarial assumptions in understanding the risks in funded defined benefit plans. The experience of entities in several countries in 2000-2003 and then again in 2007-2009 where surpluses became significant deficits, was driven by changes in asset returns (as well as discount rate changes) more than any actuarial assumption shifts. So getting much more information on these assets and the associated risks is critical and I would be wary of assuming such detail is excessive.

Other issues

Question 13

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?

I agree with all of these for the reasons you lay out.

**Transition**

**Question 15**

Should entities apply the proposed amendments retrospectively? (Paragraphs 162 and BC97–BC101)

Why or why not?

I believe that it is important to provide the measures and disclosures retrospectively for at least the time periods in the balance sheet and income statement (profit and loss).

**Benefits and costs**

**Question 16**

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?

I am not in a position to estimate the costs of implementation. However, it is clear to me that these improvements enhance the ability of users to understand the risks, enhance their forecasting ability and so improve their valuation estimates. This is based on my own experience in working with analyst teams to perform these tasks and doing it myself.

**Other comments**

**Question 17**

Do you have any other comments on the proposals?

The proposal has addressed several important issues that impact the recognition and disclosure on the balance sheet and income statement (profit and loss) but largely ignores the cash flow disclosures. This is arguably part of the financial statement presentation project but I believe should be incorporated into an amended IAS19 as the issues are not trivial. For example, is the service cost and/or contribution an operating cash item or not? If the contribution is required to make up for poor asset returns would this be part of remeasurement? There are also many additional issues in this area. Given the stated objectives of
predicting cash flows, if the Board believes that the cash flow statement contributes to such an objective, I would argue then the presentation and disclosure related to that statement must be included too.