Setting the global standard for investment professionals

5 August 2004

Sir David Tweedie
Chair of the International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

RE: Exposure Draft of Proposed Amendments to IAS 19 Employee Benefits Actuarial Gains and Losses, Group Plans and Disclosures

Dear Sir David:

The Global Financial Reporting Advocacy Committee (GFRAC) of the CFA Institute[1] is pleased to respond to the International Accounting Standards Board (IASB) Exposure Draft (ED) of Proposed Amendments to IAS 19 Employee Benefits: Actuarial Gains and Losses, Group Plans and Disclosures. GFRAC is a standing committee of the CFA Institute charged with representing the views of investors to, and maintaining a liaison with, bodies that set financial reporting and disclosure standards in a global context, particularly the IASB. The committee is also charged with responding to requests for comment from national standard setters and regulators on international financial reporting issues. GFRAC includes CFA Institute members from Asia, Europe, and North America with varying professional backgrounds and expertise in the investment industry.

General Comments

The GFRAC has consistently expressed the view that, for every recognition and measurement issue there is a preferred principle that can always be found and that all issuers should be required to recognize and measure according to that principle. Allowing for optional treatments which reflect different reporting principles almost invariably leads to the majority of issuers selecting the "least preferred" option from the investor's perspective. A further burden of this proposal for financial statements users is that they will need to understand the various optional treatments and then restate financial statements to achieve some level of consistency across issuers if they are to have any hope of making meaningful comparisons.

In the specific case of actuarial gains and losses, we believe the preferred accounting treatment is recognition in the income statement in the same accounting period that the gain or loss is recognized in the balance sheet. Therefore, we are extremely unhappy with the proposed amendments to IAS 19 as expressed in this exposure draft. Not only does it give issuers a third option, but, more critically, it also allows them to **permanently** avoid recognition of actuarial gains and losses in the income statement. We cannot support the IASB in degrading an already insufficient standard.

[1]With headquarters in Charlottesville, VA and regional offices in Hong Kong and London, the CFA Institute [formerly, the Association for Investment Management and Research® (AIMR®)] is a non-profit professional association of more than 68,000 financial analysts, investment managers, and other investment professionals in 117 countries of which 57,000 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 129 affiliated societies in 50 countries.

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If the IASB moves forward with this proposal, we would absolutely need sufficient disclosures so that investors can reclassify these gains and losses to the income statement. The ability to adjust valuation models for the full amount of the gains and losses is the only benefit we can see to the proposal. However, since one of the underlying tenets of our positions is that disclosure is not a substitute for proper recognition and measurement, we do not believe this "benefit" exceeds the "cost" of the added option.

Option to Recognize Actuarial Gains and Losses Outside of the Income Statement (Profit and Loss)

We strongly disagree with adding another option to IAS 19, *Employee Benefits.* Taking such action degrades an already insufficient standard. We urge the IASB to simply reopen IAS 19 rather than make a change that we believe will be difficult to reverse and even worse might be applied in other circumstances. End deferral of actuarial gains and losses, and require immediate recognition in the income statement. Anything different, including this proposal, will not serve investors and other users of the financial statements.

By providing an option which allows issuers to permanently avoid recognition of actuarial gains and losses in the income statement, we believe the IASB is taking a significant backward step with respect to employee benefits accounting. We also believe that such a step would have adverse economic effects in that it would encourage the belief that certain types of pension costs are not a "real" expense. We cite earlier decisions in the United States and elsewhere to permit issuers to exclude certain employee stock option awards from classification as a liability and recognition as an expense. This decision was detrimental to shareholder and investor understanding of the true cost of employee compensation, particular at those issuers where stock options form a significant portion of total compensation expense. We also believe that these standard-setters now recognize that bending to issuer pressure in the past has not made the current task of "correcting an error" any easier. We suggest that, similar to the history of accounting for employee stock options, if the IASB implements this proposal that there may be unintended consequences that will continue to haunt the standard-setting process far into the future. While imperfect, the current treatments assure that ─sooner or later─ the full cost of these employee benefits is recognized in income statement.

This is not a new position for GFRAC. In our 1997 letter to the International Accounting Standards Committee, we stated that "we are not in favor of accounting practices which allow or encourage postponing recognition of gains or losses that have already occurred." The proposed amendments not only allow postponing recognition, they permit the complete avoidance of recognition. We marvel at how the IASB can consider this to be an improved accounting treatment.

We understand that the IASB may be making these proposals because this option is preferable from a balance sheet perspective (i.e., the balance sheet numbers are "right"), but it is a disaster from an income statement perspective. Therefore, we petition the IASB not only to end deferral of actuarial gains and losses but also to provide full disaggregation of pension expense in the income statement.

Use of Provisions Relating to Multi-Employer Plans by Entities within a Consolidated Group

Currently, there is no exemption from defined benefit plan accounting available to entities under common control (such as a parent and its subsidiaries) that pool the assets contributed by each of them into a single defined benefit plan. Therefore, each entity in the group must apply defined benefit accounting.

GFRAC agrees that there should not be an unqualified exemption from defined benefit accounting for group defined benefit plans in the separate or individual financial statements of the group entities. GFRAC believes that IFRS should apply to separate or individual financial statements in the same way that they apply to consolidated financial statements. Further GFRAC believes defined benefit plan accounting for a defined benefit plan provides superior information than defined contribution accounting for a defined benefit plan. Contributions required from the subsidiaries by the parent often have more to do with the subsidiary's ability to generate cash than with its economic cost of participating in the plan.

GFRAC conditionally supports the Board's decision to allow group entities that participate in a defined benefit plan that meets the definition of a multiemployer plan to be treated as participants in a multi-employer plan in their separate or individual financial statements under the conditions set out in IAS 19, paragraph 34 as revised by the proposed ED. Our condition is based on our presumption that entities within a group will always be able to obtain sufficient information about the plan as a whole to enable them to make consistent and reasonable allocations. Thus, GFRAC expects that group entities that participate in a defined benefit plan will generally be required to apply defined benefit accounting to that plan. GFRAC would not support an amendment that would result in the application of defined contribution accounting in the separate accounts of most entities participating in a single defined benefit plan.

Additional Disclosures

Given the detrimental effect the proposals in this ED will have on accounting for pensions, we would be remiss in our responsibility to investors if we did not to use all our powers of persuasion and moral suasion to achieve the proposed increased disclosures, especially the proposed reconciliations. We would also like to see convergence between the IASB and the FASB with respect to disclosures since such convergence makes investors' use of the financial statements more efficient. We would particularly need disclosures that provide a better understanding of unfunded and partially funded plans.

However, in making this request, we would like to remind the IASB again of comments in our 1997 letter to the IASC: "The combination of less-than-ideal accounting together with disclosure which compensates for it, will result in substantial increases in the size and complexity of the notes to the financial statements, but that is the price of adopting an accounting standard with inadequate recognition requirements."

Since the proposed reconciliations are of particular importance to us, we would like to address more fully how this information improves financial analysis and hence investment valuations. The proposed reconciliations would result in a more transparent accounting system and will permit financial statement users to understand the effects on the benefit obligation and plan assets of the following

1. Acquisitions and divestitures
2. Foreign currency changes
3. Actuarial gains and losses
4. Plan curtailments and settlements
5. Plan amendments
6. Plan cash flows
7. Sponsor cash flows

Despite its inadequacies, IAS19 did improve the financial reporting for pension and postretirement plans. However, analysis is hampered by the undisclosed effects of foreign currency changes and acquisitions/divestitures. Foreign currency changes affect both assets and obligations for non-domestic subsidiaries. Acquisitions (divestitures) add (remove) assets and obligations from the consolidated group. As these effects are not disclosed under IAS 19, analysts are unable to isolate the effects of actuarial changes, plan amendments, and other events that affect plan assets and obligations.

FASB Statement 132, which resulted primarily from analyst complaints about the need for greater transparency, transformed the disclosure system under US GAAP. Consequently, financial statement users can now see all of the elements that affect plan assets and obligations. Thus they can adjust financial statements, if they wish, to alternative measures of benefit status and benefit cost. [2]

Full reconciliations permit the financial statement user to see the effects of all of the following factors:

1. Acquisitions (divestitures) of entities add (remove) plan assets and obligations from the consolidated group, under both the pooling and purchase methods of acquisition accounting. Nondisclosure of these effects can make it impossible to estimate the effects of factors 3 - 7.
2. Foreign currency rate changes affect both plan assets and obligations of non-domestic subsidiaries. Nondisclosure of these effects can make it impossible to estimate the effects of factors 3 - 7.
3. Actuarial gains and losses are an important measure of the reasonableness of management's assumptions. While the effects of changes in the discount rate and rate of compensation increase receive much attention, other undisclosed assumptions also result in actuarial gains and losses. Reconciliation of the benefit obligation enables users to see the entire amount of actuarial gains and losses.
4. Plan curtailments and settlements can have significant effects on benefit cost as well as plan status.
5. Plan amendments result in unamortized amounts that may affect benefit cost for many years. Frequent amendments may also suggest that the benefit obligation is understated.
6. Plan cash flows are often a leading indicator of sponsor cash flows. Benefit payments can be highly variable over time.
7. Sponsor cash flows represent the immediate effect of benefit plans on the corporate sponsor. Such cash flows are usually very different from benefit cost (reported or alternative measures).

We strongly believe the reconciliations proposed in the exposure draft would provide the information set and the needed transparency for the accounting for pensions and other postretirement benefits.

Despite this demonstration of the importance of these disclosures to investors, we will be amazed if the issuers and auditors who comment on these proposed amendments are willing to pay this price. Rather we suspect that they will lobby heavily for permanent deferral of actuarial gains and losses without adequate disclosures for investors to make the necessary adjustments to the income statement in their valuation models. When issuers have the ability to select sub-standard accounting treatments, it is simply essential that investors be given any disclosure that permits them to compensate for the accounting.

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[2] White, Sondhi, and Fried, *The Analysis and Use of Financial Statements* (Third Edition, 2003) shows (pages 405 ff) how to use the reconciliations of plan assets and obligations required by SFAS 132. As discussed on page 431, the IAS 19 disclosures are inadequate to perform similar analyses.

We fully expect to be castigated for our request for these disclosures and to be accused of insatiable appetites in that regard. We ask the Board in its final deliberations to weigh carefully mandating the proper accounting rather than layering on substantial compensating disclosures to a poor recognition model.

Concluding Remarks

The GFRAC appreciates the opportunity to comment on this Exposure Draft. If you or the IASB staff have any questions or require further elaboration of our views, please do not hesitate to contact Patricia Doran Walters, CFA, at 1.434.951.5315 or patricia.walters@cfainstitute.org.

Sincerely,

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