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Mr Jean-Paul Gauzès
EFRAG Board President
35 Square de Meeûs

B-1000 Brussels

Berlin, […] November 2019

Dear Jean-Paul,

EFRAG Discussion Paper *Accounting for Pension Plans with an Asset-Return Promise*

On behalf of the Accounting Standards Committee of Germany (ASCG) I am writing to comment on the Discussion Paper *Accounting for Pension Plans with an Asset-Return Promise* issued by EFRAG on 15 May 2019 (herein referred to as 'DP'). We welcome EFRAG's active role in the current discussions on pension accounting and appreciate the opportunity to comment on the DP.

In our view, EFRAG's DP is an additional valuable contribution to the ongoing debate on pension accounting. It addresses the important question, how pension accounting can be improved and should be developed further as regards pension plans that are linked to asset returns. The DP examines three alternative accounting approaches for pension plans with an asset-return promise: (1) the Capped Asset Return approach, (2) the Fair Value-based approach and (3) the Fulfilment Value approach. It does not express an explicit preference for one of the approaches presented but encourages the Fair Value-based approach and the Fulfilment Value approach.

We concede that the Fair Value-based approach and, especially, the Fulfilment Value approach (being consistent with the latest IFRS developments and IFRS 17), may be more promising solutions from a purely conceptual point of view. However, considering the pension accounting discussions over the last years and the condition not to rethink IAS 19's accounting and valuation approach fundamentally, we do not favour an introduction of any of these approaches. We believe that the Capped Asset Return approach better fits the current standard and represents a preferable solution in terms of costs and benefits.

Our view is in line with the feedback we received on our research performed together with Canada, Japan, the U.K. and the U.S. on hybrid pension plans (cf. https://www.ifrs.org/-/media/feature/meetings/2018/july/asaf/ap7-research-on-pensions-hybrid-plans.pdf). At the September 2017 IFASS meeting, IFASS members showed little support for the Fulfilment Value approach. Those who supported it did so as a longer-term solution, since it would require a complete rewrite of IAS 19, and it might be best to wait and see how the implementation of IFRS 17 *Insurance Contracts* proceeds and how the standard is perceived in practice.

[space for further key messages]

Our detailed comments in response to the ED questions are laid out in the appendix to this letter. If you would like to discuss our comments further, please do not hesitate to contact Kristina Schwedler (schwedler@drsc.de) or me.

Yours sincerely,

Andreas Barckow

President

QUESTION 1 - SCOPE The Discussion Paper addresses only those pension plans that have an asset-return based promise and hold the assets upon which the benefits are dependent. Do you think that the approaches could also be applied to those plans with an asset-return promise, where the plan does not hold the reference assets?

Yes, we do believe that the approaches can equally applied to plans where the plan does not hold the reference asset.

Paragraph 2.7 states that there is a different risk exposure for the reporting entity in the case that (1) the plan holds the reference assets and (2) the plan does not hold the reference assets. In the first case the economic covariance between the pension obligation and plan assets is evident. In the second case, the entity is additionally exposed to the risk that the return earned on any alternative investment (positively or negatively) deviates from the return on the specified pool of reference assets.

Discussion results of the ASCG's Working Group on Pensions ("AG Pensionen")

- *The different risk exposure is no reason to exclude plans that do not hold the reference assets, since the separate valuation of (plan) assets and the defined benefit obligation within the pension liability is an integral part of the fundamental concept of IAS 19 to measure an entity's pension obligation towards its beneficiaries.*
- *The adequate measurement of an asset-based pension promise should primarily be focussed on the adequate measurement of the defined benefit obligation, rather than on the measurement of the covering assets.*
- *The performance risk of assets other than the reference assets is reflected adequately by the overall IFRS-measurement objectives. If those assets qualify as plan assets their fair value measurement combined with the p&l effective recognition of the asset return at the level of the IAS 19-discount rate and related disclosures give a true and fair view on the additional performance risk in the terms of IAS 19. And even if those assets do not qualify as plan assets, their measurement will still provide a true and fair view on additional performance risk in line with the IFRS's general measurement principles.*
- *The three approaches presented in the DP seem to be applicable not only in cases where assets qualify as plan assets but also in cases where assets are recognised as other assets or are not held at all (notional assets).*
- *Therefore, the approaches could also be applied to those plans with an asset-return promise, where the plan does not hold the reference assets.*

QUESTION 2 – ASSESSMENTS OF APPROACHES – ASPECTS TO CONSIDER Do you agree with the aspects of qualitative characteristics considered in the assessment of the various approaches in Chapter 5? If not, which aspects do you think should/should not have been considered?

Do you agree with the assessments of the various approaches made in Chapter 5?

We do not completely agree with the assessment made, as detailed below.

Discussion results of the AG Pensionen

- *The assessment criteria reflect the qualitative characteristics of useful financial information as set out in the Conceptual Framework as well as the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002. Accordingly, they form an appropriate foundation. However, the assessment highlights specific aspects while other aspects remain unconsidered, e.g. verifiability and reliability. Both a comprehensive weighting of the assessment criteria and an overall assessment are missing.*

Regarding particular assessment criteria and questions, our conclusion differs on the following points:

- *Is the economic covariance between plan assets and pension obligation reflected?*
  The Capped Asset Return approach eliminates the measurement inconsistency – and, hence, the inconsistency in the estimate of the cost of the benefits to be paid – that arises because the variability (risk) of future asset returns is reflected only in the cash flows and not in the discount rate applied to those cash flows. As a result, the covariance between plan assets and pension obligation is significantly better reflected than under the current IAS 19 approach. (two stars instead of one star for the Capped Asset Return approach)
- *Does the calculation of current service cost result in a useful reflection of pension cost related to a particular period?*
  The Capped Asset Return approach better reflects the pension cost related to a particular period due to the elimination of the measurement inconsistency mentioned above. (one star instead of two stars for the current IAS 19 approach)
  Furthermore, it should be noted that the Fair Value-based approach and the Fulfilment Value approach systematically do not take any backload correction into account (despite the fact that this is mandatory under IAS 19). Hence, it is questionable whether these approaches better reflect the pension costs related to a particular period. (two stars instead of three stars for the Fair Value-based approach and the Fulfilment Value approach)
- *Is information about the value of the minimum return guarantee provided?*
  The DP's assessment considers only a separate measurement of the minimum return guarantee. However, the current IAS 19 approach as well as the Capped Asset Return approach incorporate the guarantee element as well, although not separately but as part of measuring the DBO. Therefore, the two afore mentioned approaches contain information about the value of the minimum return guarantee, too. (one star instead of no star for the current IAS 19 approach and the Capped Asset Return approach)
- *Is the employee's right to receive the higher of the return on plan assets and the minimum guaranteed return reflected in a complete manner?*
  The Capped Asset Return approach reflects the employee's right to receive the higher of the return on plan assets and the minimum guaranteed return more adequately than the current IAS 19 approach, since the current IAS 19 approach does not link the defined benefit obligation to the actual fair value of the reference assets, whereas the Capped Asset Return approach does. (two stars instead of one star for the Capped Asset Return approach)
- *Is the obligation element related to the minimum guaranteed return accounted for similarly to plans under IAS 19?*
  The Fair Value-based approach and the Fulfilment Value approach differ fundamentally from all other measurement approaches under IAS 19, including pension promises where

benefits exactly match the proceeds from an underling qualifying insurance contract or reimbursement right, such that similar accounting treatments cannot be expected. (no star instead of one star for the Fair Value-based approach and the Fulfilment Value approach)

- *Is the obligation related to the return on plan assets accounted for similarly to plans under IAS 19?*
  For the same reasons as those set out in the previous question. (two stars instead of one star for the Capped Asset Return approach; no star instead of three stars for the Fair Value-based approach and the Fulfilment Value approach)
- *Is the information understandable?*
  Even after long and intensive expert discussions on the Fulfilment Value approach we did not end up in a commonly agreed and comprehensive understanding of how this approach works in detail and should be applied practically. We therefore come to the conclusion that this approach is overly complex and hard to understand. (no star instead of two stars for the Fulfilment Value approach)
  The Capped Asset Return approach is seen as easy to understand, in particular as it is based on existing principles in IAS 19 that preparers, auditors and actuaries as well as users are familiar with. (two stars instead of one star for the Capped Asset Return approach)
- *Will the implementation of the approach be uncostly?*
  For the Capped Asset Return approach, the implementation costs are assessed as negligible. (tree stars instead of two stars for the Capped Asset Return approach)
  The Fulfilment Value approach is seen as more complex than the Fair Value-based approach with corresponding higher implementation costs. (no star instead of one star for the Fulfilment Value approach)

QUESTION 3 - ASSESSMENT OF APPROACHES – ASSESSMENT OF COMPLEXITY The assessment in Chapter 5 of the costs related to the various approaches presented in this Discussion Paper, only considers implementation costs. Do you think that the complexity related to preparing financial information in accordance with the approaches would differ significantly? If yes, which approaches would be the most complex and least complex to apply?

We do believe that the complexity involved in applying the approaches differ significantly, with the Capped Asset Return approach being the least complex and the other two being equally more complex to apply.

Discussion results of the AG Pensionen

- *The complexity related to preparing financial information depends on the plan design. In the DP a variety of assumptions are made which keep the example simple. On the one hand, this allows to present certain interdependencies more clearly. On the other hand, this kind of simplification bears the risk that other relevant factors are not taken into account and that the overall complexity existing in reality is not being depicted appropriately.*
- *For example, the DP does not describe how disability, death-in-service and longevity influence the measurement of the pension liability. Only one employee and one scenario are considered. Therefore, the example is too simplistic and therefore does not properly reflect the prevailing measurement complexity and costs related to the various approaches.*

- *The Fair Value-based approach and the Fulfilment Value approach require additional complex simulations and valuations. We are aware that Option Pricing Models are used under IFRS 4 and will be required under IFRS 17. However, the use of Option Pricing Models is challenging. We doubt that the additional benefit (if any) justifies the costs of such valuations and believe that one should wait and consider any experiences made with implementing IFRS 17 before applying such approaches to different fact pattern and all industries.*
- *Especially under the Fulfilment Value approach, stochastic simulations become necessary (e.g. Monte Carlo Simulations). Such models are complex and sensitive to the various parameter constellations and would leave scope of discretion resulting in a potentially critical lack of comparability. Moreover, the results of such simulations may not be easily reproducible by a third party (such as an actuary or an auditor) and as a consequence, may lead to increased auditing requirements and procedures.*
- *As a result, the Capped Asset Return approach is assumed to be less complex than the Fair Value-based approach and Fulfilment Value approach and would lead to lower valuation expenses.*

QUESTION 4 – CHOICE OF APPROACH Which of the three alternative approaches, presented in this Discussion Paper, do you support? How should it be further developed?

Discussion results of the AG Pensionen

- *With reference to the discussion results regarding question 2 and 3 and against the background that no fundamental rethinking of IAS 19 is intended, the Capped Asset Return approach is the preferred approach. It better fits into the standard and represents a preferable solution in terms of associated costs and benefits.*
- *The Capped Asset Return approach should be further developed into a Fixed Asset Return approach, in which the expected return included in the valuation is replaced by the technical discount rate. This is seen as consistent with the amendments to IAS 19 in 2011 (Elimination of the expected return from the expense calculation and replacement by the discount rate) and even in cases where the expected return is below the discount rate, the obligation would be measured appropriately.*

QUESTION 5 - PRESENTATION OF REMEASUREMENTS UNDER THE FAIR VALUE BASED APPROACH AND THE FULFILMENT VALUE APPROACH This Discussion Paper assumes that remeasurements under the Fair Value Based approach and the Fulfilment Value approach are presented in profit or loss. Do you agree with this approach? If not, how would you present components of defined benefit costs other than service costs?

Discussion results of the AG Pensionen

- *The assumption that remeasurements under the Fair Value-based approach and the Fulfilment Value approach are presented in profit or loss does not correspond with IAS 19.*
- *IAS 19 requires the recognition of interest expense on a defined benefit plan and also the recognition of interest income, if the reporting entity accounts for plan assets with regard to that plan in profit and loss whereas remeasurements are recognized in other*

comprehensive income. While the Capped Asset Return approach is consistent and in line with that principle, both the Fair Value-based approach and the Fulfilment Value approach are not. Not recognising interest expenses (accrued interest of DBO) or fictious interest expense that is independent from the discount rate are generally viewed as giving rise to a mismatch with interest income on the asset side.

- *As a result, the comparability of financial data for different pension plans is limited.*

QUESTION 6 - RISK ADJUSTMENT FOR FULFILMENT VALUE APPROACH As stated in paragraphs 4.56 to 4.57, this Discussion Paper proposes that a risk adjustment for non-financial risks is made when discounting the pension obligation under the Fulfilment Value approach. Do you agree? Which risks do you consider such an adjustment should cover?

Discussion results of the AG Pensionen

- *Such risk adjustments for non-financial as well as for financial risks leave scope for discretion.*
- *This significantly restricts the comparability of financial information and is not in line with the 2011 amendments of IAS 19 (cf. Basis for Conclusion par. 129 ff).*

QUESTION 7 – DISCLOSURE Do you think that additional disclosure requirements about pension plans, included in scope of this Discussion Paper, should be added to the requirements of IAS 19?

Discussion results of the AG Pensionen

- *The Group agrees with the conclusion that the application of alternative accounting approaches call for additional disclosure requirements.*
- *Since the Fair Value-based approach and the Fulfilment Value approach significantly differ from the current accounting concept, it is likely that information on these approaches cannot be combined with existing notes. This means that the introduction of any of these approaches require / will lead to additional disclosures.*
- *Due to the higher complexity of the Fair Value-based approach and especially of the Fulfilment Value approach we also expect the disclosures to be more complex and more difficult to understand.*

QUESTION 8 – ALTERNATIVE APPROACHES Do you think there are other approaches to account for the pension plans within the scope of this Discussion Paper that should have been considered? If so, which approaches?

Chapter 7 contains a brief description of other possible accounting approaches, namely the D9 approach, component approaches and an IAS 19 approach with no backload correction.

Discussion results of the AG Pensionen

- *Pension plans that depend on assets returns and include a minimum guarantee have been existing in Germany for quite a long time. The minimum guarantee is a core element of the German occupational pension system.*
- *In practice, an accounting method based on IFRIC's D9 approach rather has been used rather than what the DP refers to as the current IAS 19 approach. The German accounting practice follows this approach broadly and consistently and, apparently, this solution is perceived as efficient and comparable by preparers, auditors, investors and enforcers. Hence, from a German perspective, any approach similar to the D9 approach is of particular interest.*
- *No material deviations from the current accounting figures are expected with the introduction of the Capped Asset Return/ Fixed Asset Return approach.*