Financial Accounting Standards Board
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October 17, 2016

Subject: Agenda consultation
File Reference No. 2016-290

Dear Chairman Golden:

On behalf of Mercer, we appreciate the opportunity to comment on potential agenda topics.

Our comments are limited to Chapter 2.

We do not feel we are in a position to weigh the importance of examining pension accounting vs other topics, so will not express any opinion on that question. However if the Board should choose to adopt a broad pension topic, we believe certain fundamental issues should be addressed. We have incorporated our thoughts into the answers to the questions posed in the ITC.

Question 2.1: Is the accounting for pensions and other postretirement benefit plans a major financial reporting issue that the FASB should consider for improvement? Please explain why.

No comment.

Question 2.2: Would Alternative A (see paragraphs 2.15–2.16) and/or Alternative B (see paragraphs 2.17–2.19) improve the usefulness of financial information provided to users and be operable?

Simply because it would provide greater worldwide comparability, and would avoid forcing companies that report on both IFRS and US GAAP to obtain two sets of accounting reports from their pension actuary, we prefer alternative A. We understand, though, that these are practical considerations and that theoretical considerations also come into play.
Question 2.3: If you support Alternative A (convergence with IAS 19), would you recommend any modifications to IAS 19 or would you expect any implementation issues? Please explain why.

Other than a decision as to the resolution of amounts currently held in AOCI, at this time we do not see any significant implementation issues with the accounting. Some issues—probably none of them insurmountable—could arise if disclosure requirements were expanded.

Question 2.4: Are there other approaches to consider for addressing the issue of delayed recognition in earnings? If so, please provide them in sufficient detail so that the FASB can consider your proposal(s). Please provide your rationale for why your proposal provides users of financial statements with more useful information.

No Comment.

Question 2.5: Is the current measurement of a defined benefit obligation appropriate? If not, what changes do you suggest and why (for example, what characteristics of plans are not adequately reflected in the current measurement of the benefit obligation)?

We believe the current measurement approach is somewhat flawed. Our concerns are:

1. We are concerned about the current requirement to use AA bonds or higher in determining discount rates. While we are comfortable with the requirement to use high-quality bonds, we understand that many believe that the criteria for bond rating have changed over the last 20 years. The number of bond issues that are AA (or AAA) seems to have dropped significantly but that drop does not necessarily reflect a correspondingly significant change in the relative viability/quality of US corporations. The result has been a significant narrowing of the number of bonds available, especially at longer durations, to match plan cashflows. If the trend continues, discount rates will be based on the interest rates underlying bonds of just a few companies, and we do not think that investor opinion regarding a few companies should drive the valuation of the pension obligations of all of corporate America.
2. We are concerned about the inconsistency of measurement between various types of plans. One inconsistency is the question of hybrid plan accounting that you have already noted. However we believe the issue goes beyond that. To help in deliberations on the amendments to IAS 19, the IASB staff developed an excellent schematic that demonstrated how the current measurement paradigm forced discontinuities between various types of DB plans and between DC and DB plans. The discontinuities are created as a result of the use of a salary scale assumption—the requirement that even though an employee must work additional years of service and the employer must make an economic decision in the future to provide pay increases, the company should guess at the decisions it will make in the future and generate a liability that is unrelated to service worked as of the measurement date. We understand that this issue is not today generating significant press. But as actuaries, we also see companies making decisions to create income by eliminating liabilities that don’t exist. This is a situation where the accounting rules are creating rather than preventing results with little to no meaning.

3. Hybrid plans contain a variety of features, such as embedded options and benefits, that are sensitive to investment returns and that do not necessarily lend themselves to the traditional valuation approach of projecting cash flows using “best estimate” assumptions and then discounting those cash flows based on market yields. While some actuaries and auditors have gotten comfortable interpreting existing standards to permit a reasonable market-based measurement of obligations for these plans, others have taken a narrower view that may result in a lack of comparability between plans and between companies. We believe that the American Academy of Actuaries might be willing to help develop a theoretical framework for the valuation of these obligations if it is clear that the FASB would consider updating existing standards to reflect this discussion, and would be happy to approach them on your behalf.

Question 2.6: What approach (that is, targeted improvements or comprehensive reassessment) would you recommend and why?

In previous letters we have indicated that we believe that making sure the measurement is correct is the first step before working around the edges and we continue to hold that position.
Question 2.7: Are there other issues for pension and other postretirement benefit plan accounting that should be considered for improvement?

Yes. Last year the SEC approved the calculation of interest cost based on the use of a market relevant yield curve rather than a flat yield curve. (The use of a single average rate is fundamentally identical to a flat yield curve; the only difference is nomenclature.) However they limited the use of the market curve to plans that were at that time using yield curves to develop discount rates. This year they concluded that companies using a bond model could not adopt such an approach. This is creating significant comparability issues in that two companies with identical plans and very similar PBOs will have widely different interest cost, depending on which method was used to determine the PBO and when the decision was made to adopt that method. The average rate approach was adopted at a time when understanding of the elements of market yields was significantly less widespread, and the computing tools needed to reflect market yield curves were not practically available. We believe that ASC 715 should be clarified to specifically allow the use of the term structure of interest rates where appropriate, and that comparability between companies is not compromised. The SEC indicated that disclosure is available to explain the lack of comparability, but in the words of a FASB Board member in 2006 when SFAS #158 was being developed, "good disclosure is not a substitute for good accounting."

Thank you for your consideration of our thoughts

We appreciate your consideration of these comments. If we can provide any additional clarification or assistance, please call Jim Verlautz at 612 642 8819 or Bruce Cadenhead at 212 345 7257.

Sincerely,

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Chief Actuary – US Retirement
Mercer

Copy: Jim Verlautz