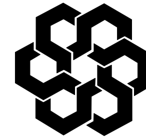

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**17 November 2006, London**
Project:	**Post-employment Benefits**
Subject:	**Recognition of changes in defined benefit pension plans (Agenda Paper 4A)**

Introduction

1. Phase 1 of the post-employment benefits considers revisions to IAS 19 that would achieve significant short-term improvements to the accounting for post-employment benefits. These potentially include the recognition of amounts previously unrecognised in accordance with IAS 19.

2. At its July meeting, the Board decided to form an Employee Benefits Working Group, to help the IASB take a fresh look at financial reporting of employee benefits. The Board will consult with the working group on important decisions and the views of the working group members will be included in the materials for discussion in IASB meetings. However, the purpose of the working group is not to develop proposals, nor to vote on proposals brought to it by the staff. Rather, the working group is expected to provide practical advice and input on the concepts, ideas and proposals developed by the IASB and staff.

3. The staff notes that this paper, and Agenda paper 4B that accompanies it, have not yet been discussed with the working group. The staff intends to discuss the contents of these papers and the Board's response to them with the working group in due course. The views of working group members will be presented to the Board at a future meeting.

4. This paper considers the recognition of the following amounts that IAS 19 does not require be recognised in the period in which they occur:

   (a) some actuarial gains and losses, as determined by the entity's accounting policy.

   (b) unvested past service cost.

5. Many argue that IAS 19 leads to distorted reported results. Although the information needed to remove that distortion is available in the notes, it is often argued that this information is difficult for many users to understand.

6. The staff has not attempted to repeat the all the analysis found in the Basis for Conclusions to IAS 19, FASB Statement No 87 and FASB Statement 158. Most Board members are familiar with those discussions, but we have included them as attachments to this paper (pages 73-120 of IAS 19, 30-69 of SFAS 87 and 61-101 of SFAS 158). [Not reproduced for observers.]

Staff recommendations

7. The first publication in phase one of the project is expected to be a Discussion Paper. The staff recommendations in this paper and Agenda Paper 4B are recommendations to establish the Board's preliminary views for inclusion in the Discussion Paper. The staff recommends that the Board:

   (a) requires immediate recognition of all actuarial gains and losses.

   (b) requires immediate recognition of all unvested past service costs.

8. Agenda paper 4B discusses where these amounts should be presented.

Staff analysis

Actuarial gains and losses

9. Actuarial gains and losses result from the effects of changes in actuarial assumptions, and differences between the previous actuarial assumptions and what has actually occurred (experience adjustments).

10. Under IAS 19 some actuarial gains and losses do not have to be recognised immediately, but can be deferred. Actuarial gains and losses that do not exceed the corridor[1] do not need to be recognised. In addition, actuarial gains and losses that exceed the corridor can be spread over the service lives of the employees. IAS 19 also permits entities to recognise actuarial gains and losses in full, either in profit loss or in total recognised income and expense.

11. The following paragraphs discuss whether the Board should require that actuarial gains and losses be recognised in full in the period in which they occur.

Deferred recognition

12. In a deferred recognition approach, certain changes in the pension obligation and changes in the value of plan assets are not recognised as they occur but are recognised systematically and gradually over subsequent periods. All changes are ultimately recognised except to the extent that they may be offset by subsequent change; but, at any point, changes that have been identified and quantified await subsequent accounting recognition as net cost components and as liabilities or assets.

13. The arguments put forward for deferred recognition of actuarial gains and losses are:

    (a) immediate recognition implies a degree of accuracy of measurement that can rarely apply in practice. It would result in recognition of actuarial gains and losses that do not properly belong to the period and that do not normally denote definite changes in the underlying assets or liability. This would create volatile fluctuations in the balance sheet and income statement that simply reflect an unavoidable inability to predict accurately the future events that are

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[1] The corridor is the greater of 10% of the plan assets and 10% of the plan liabilities.

anticipated in making period-to-period measures. In the long-term, actuarial gains and losses may offset each other.

(b) following on from this view, deferred recognition allows the use of objective measures, such as market values for plan assets. Immediate recognition would only be appropriate if the measurement bases for the assets and liabilities were long-term measures that excluded artificial and irrelevant short-term volatility.

(c) whether or not the volatility resulting from immediate recognition is a true reflection of economic events of the period, it is too great to be acceptable in the financial statements. It would swamp the results and financial position of the business operations and it may cause entities to close their defined benefit plans.

14. The arguments that refute those points are:

(a) Deferred recognition attempts to avoid volatility. However, a financial measure should be volatile if it purports to represent faithfully transactions and other events that are themselves volatile.

(b) If the post-employment benefit figures are large compared to others in the financial statements, this reflects the economic reality that the post-employment plan(s) are large compared to the business operations.

(c) The wrong accounting should not be continued simply to encourage entities to keep their defined benefit plans open. The role of accounting is to report transactions and events in a neutral manner, not to give favourable or unfavourable treatment to particular transactions to encourage or discourage entities to engage in those transactions. To do so would impair the quality of financial reporting.

(d) It is not reasonable to assume that all actuarial gains and losses will be offset in future years: on the contrary, if the original actuarial assumptions are still valid, future fluctuations will, on average, offset each other and thus will not offset past fluctuations.

(e) Although the ultimate cash outflow does not emerge until the long-term, paragraph 34 of the Framework notes that it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement despite inherent difficulties either in identifying the transactions

and other events to be measured, or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events.

Immediate recognition

15. Arguments for an immediate recognition approach include:

    (a) It represents faithfully the entity's financial position. An entity will report an asset only when a plan is in surplus and a liability only when a plan has a deficit. In contrast, when recognition is deferred, any net cumulative unrecognised actuarial losses give rise to a debit item in the balance sheet that does not meet the definition of an asset. Similarly any net cumulative unrecognised actuarial gains give rise to a credit item in the balance sheet that does not meet the definition of a liability.

    (b) The figures in the balance sheet and income statement are transparent and easy to understand. The approach generates income and expense items that are not arbitrary and that have information content.

    (c) The balance sheet treatment is consistent with the approach taken by the Board in its other projects, in particular on non-financial liabilities. Immediate recognition is also consistent with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* which requires that changes in accounting estimates that give rise to changes in assets and liabilities are recognised by adjusting the carrying amount of the related asset or liability in the period of the change. [2]

    (d) Deferral approaches are not used for other uncertain assets and liabilities, and it is not clear why they should be used for post-employment benefits.

    (e) Immediate recognition requires less disclosure because all actuarial gains and losses are recognised.

    (f) Deferred recognition and 'corridor' approaches are complex, artificial and difficult to understand. They add to cost by requiring entities to keep complex records. With immediate recognition, the complex and arbitrary rules needed

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[2] IAS 8, paragraph 37. IAS 8, paragraph 32 also notes that "as a result of the uncertainties inherent in business activities, many items in financial statements cannot be measured with precision but can only be estimated."

to govern the deferral of gains and losses are not required, resulting in a shorter, simpler, principles-based standard.

(g) Requiring all entities to recognise all actuarial gains and losses immediately will improve comparability across entities compared to the various options that are included in IAS 19.

16. The staff also notes that successive Boards have recognised the conceptual merits of immediate recognition as follows:

(a) In paragraph 107 of SFAS 87, "Employers' Accounting for Pensions", the US standard, the FASB noted that immediate recognition "would be conceptually appropriate and preferable". While concluding that such an approach "would be too great a change from past practice to be adopted at the present time", the FASB acknowledged "that the delayed recognition included in [SFAS 87] results in excluding the most current and most relevant information from the employer's statement of financial position.[3]"

(b) In the Basis for Conclusions to IAS 19, the IASC Board noted the attractions of an immediate recognition approach. However, it noted that "noted that it would not be feasible to use this approach until substantial issues about performance reporting were resolved." Agenda paper 4B discusses presentation. In July 2002, the Board discussed recognition of actuarial gains and losses in a later-aborted convergence project on post-employment benefits. At that meeting, the Board tentatively decided to require immediate recognition of all actuarial gains and losses.

(c) When adding the option for immediate recognition outside profit or loss, the IASB stated in its Basis for Conclusions[4] that it "does not agree that deferred recognition is better than immediate recognition of actuarial gains and losses. The amounts recognised under a deferral method are opaque and not representationally faithful, and the inclusion of deferral methods creates a complex difficult standard."

(d) In September 2006, the FASB published the results of phase 1 of its post-employment benefits project, SFAS 158 *Employers' Accounting for Defined*

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[3] paragraph 104

[4] IAS 19 Basis for Conclusions, paragraph 48O

Benefit Pension and Other Postretirement Plans. It requires immediate recognition of the overfunded or underfunded status of a defined benefit postretirement plan, with actuarial gains and losses that were not recognised under SFAS 87 recognised as a component of other comprehensive income. In paragraph B30 of this Standard, the FASB noted 'that financial reporting will be significantly improved by requiring recognition in an employer's statement of financial position of the funded statuses of its sponsored defined benefit postretirement plans other than multiemployer plans. The Board believes that recognition requirement will significantly improve the understandability of reported financial information, thereby facilitating analysis of an employer's financial reports.'

17. The staff view is that the conceptual arguments for immediate recognition are overwhelming and **recommends that the Board requires immediate recognition of all actuarial gains and losses,** subject to developing proposals for their presentation as discussed in Agenda Paper 4B**.**

Past service cost

18. Past service cost arises when an entity introduces a defined benefit plan with benefits attributed to past service or changes the benefits attributed to past service under an existing defined benefit plan.

19. Under IAS 19, past service costs may be vested or unvested. Vested past service costs are recognised immediately. Unvested past service cost are recognised as an expense on a straight-line basis over the average period until the benefits become vested. As a result, in any period, some unvested past service cost may not be recognised.

20. Recognition of all past service cost has the following advantages (described in the Basis for Conclusions to IAS 19):

    (a) amortisation of past service cost is inconsistent with the view of employee benefits as an exchange between and an entity and its employees for services rendered: past service cost relates to past events and affects the employer's present obligation arising from employees' past service. Although an entity

may improve benefits in the expectation of future benefits, an obligation exists and should be recognised;

(b) deferred recognition of the liability reduces comparability; an entity that retrospectively improves benefits relating to past service will report lower liabilities than an entity that granted identical benefits at an earlier date, yet both have identical benefit obligations. Also, deferred recognition encourages entities to increase pensions instead of salaries;

(c) past service cost does not give an entity control over a resource and thus does not meet the *Framework*'s definition of an asset. Therefore, it is not appropriate to defer recognition of the expense; and

(d) there is not likely to be a close relationship between cost—the only available measure of the effect of the amendment—and any related benefits in the form of increased loyalty.

21. However, the Basis for Conclusions to IAS 19 concludes that past service cost should be amortised over the vesting period because:

(a) once the benefits are vested, there is clearly a liability that should be recognised; and

(b) although non-vested benefits give rise to an obligation, any method of attributing non-vested benefits to individual periods is essentially arbitrary. In determining how that obligation builds up, no single method is demonstrably superior to all the others.

22. A view not explored in the Basis for Conclusion to IAS 19 is that the concept of an unvested past service cost is a paradox. If an employer provides increased benefits that have a vesting period, those benefits must be provided in exchange for the employee's future services until vesting date. This view is consistent with the treatment of changes in share-based benefits under IFRS 2 and the proposed treatment of unvested termination benefits as a stay bonus in the July 2005 ED of amendments to IAS 19.[5] The consequences of this view are discussed below.

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[5] Paragraph BC12 of that ED notes that "in some cases, termination benefits that are payable in exchange for future service would be calculated using a benefit formula that determines some (or all) of the termination benefits with reference to past service. However, the Board agreed with the FASB that the benefit formula 'in and of itself, does not render one-time termination benefits a 'reward' for past service. The [FASB] observed that an objective of providing a 'reward' for past service could be

Example

23. An entity promises a benefit of CU100 for each year of service to employees that remain employed at the end of a 5 year period. In this example, assume that all employees remain employed at the end of 5 years

24. The amount recognised in each year for each employee are as follows:

	x1	x2	x3	x4	x5
Expense recognised[6]	100	100	100	100	100

25. At the end of x2, the entity decides to increase the benefit to CU200 per year.

26. Thus, under IAS 19:

(a) the amount of benefit attributable to each year of service becomes CU200.

(b) at the end of x2, there is CU200 of unvested past service cost.

27. Under IAS 19, the unvested past service cost of CU200 is treated as a liability whose recognition is deferred by spreading it over the remaining vesting period. The entity recognises the following amounts for each employee:

	x1	x2	x3	x4	x5
original benefit	100	100	100	100	100
additional benefit			100	100	100
unvested past service cost			67	67	67
Expense recognised	100	100	267	267	267
Unrecognised liability			134	67	0

28. The IFRS 2/termination benefit approach would treat the increase in benefit of CU500 as remuneration for the period until the increase in benefit vests. That view would result in the following amounts recognised for each employee:

accomplished by granting immediately vested benefits.'* Accordingly, the Board concluded that such benefits should be recognised over the future service period, even though they are calculated by reference to past service."

[6] Discounting has been ignored to simplify the example.

	x1	x2	x3	x4	x5
original benefit	100	100	100	100	100
additional benefit			167	167	167
Expense recognised	100	100	267	267	267
Unrecognised liability			0	0	0

29. Although the amounts recognised are the same as those under the IAS 19 approach, the reason behind it is different. Here, the additional benefit of CU500 is viewed as relating to the future periods until vesting date. There is no liability at the end of x2. Under the IAS 19 approach, CU300 of the additional benefit relates to the future periods until vesting date and CU200 relates to past periods. The entity has a liability of CU200 at the end of x2 whose recognition is deferred over the remaining periods until vesting.

30. Immediate recognition of unvested past service cost would give the following result:

	x1	x2	x3	x4	x5
original benefit	100	100	100	100	100
unvested benefit			100	100	100
unvested past service cost			200		
Expense recognised	100	100	400	200	200

31. Thus, immediate recognition would lead to a change from current practice under IAS 19. But, in fact, that current practice happens also to give answers consistent with what the Board has argued is the best conceptual answer in IFRS 2 and the proposed amendments to IAS 37.

32. However, the concept of an unvested past service cost giving rise to a liability arises from IAS 19's reliance on the benefit formula to calculate the projected benefit obligation. It is beyond the scope of this project to change the calculation of the projected benefit obligation or the reliance on the benefit formula. The

question for this therefore paper is whether the *liability that exists* under IAS 19 should be recognised.

33. **The staff therefore recommends that, within the context of phase 1 of the post-employment benefits project, unvested past service cost as defined in IAS 19 should be recognised immediately.**