30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **3 November 2006, London**

Project: **IAS 19: *Employee Benefits* - Outstanding IFRIC issues (Agenda Paper 8)**

---

1 As part of its review of all outstanding issues, IFRIC has requested a status report on the various IAS 19 issues that have come before it or been raised with the IFRIC staff.

2 This paper provides a summary of the nine outstanding IAS 19 issues that have been raised with the IFRIC. Eight of these issues were discussed at the June 2005 meeting. One new issue has recently been put forward for the IFRIC's consideration. The staff has grouped these issues into three separate groups: Group 1 - Active issues currently under development; Group 2 – Issues pending deliberation; Group 3 – Issues to be completed as and when staff resources allow.

3 The issues were categorised by the IFRIC at the June 2005 meeting. In particular, the key issues in determining the priority for addressing the outstanding issues for interpretation by IFRIC are the same as the criteria for determining whether to recommend that an issue be included on the IFRIC agenda. Under paragraph 27 of the Preface to International Financial Reporting Interpretations, an issue should satisfy some or all of the following criteria:

- have practical and widespread relevance;

- involve significantly divergent interpretations (either emerging or already existing in practice);
- be likely to result in a consensus view of the IFRIC on a timely basis;
- be unrelated to a Board project that is expected to be completed in the near future.

4 The IASB has recently added to its agenda an active project on post-employment benefits. That project will involve a fundamental review of all aspects of post-employment benefit accounting, including the definition of defined benefit and defined contribution arrangements and accounting for cash balance plans and similar arrangements. The project is to be conducted in two phases, the second of which will involve a fundamental review of all aspects of post-employment benefit accounting.

5 The first phase will consider issues that can be resolved within the next four years, namely:

- presentation and disclosure
- definition of defined benefit and defined contribution arrangements and
- accounting for cash balance plans
- smoothing and deferral mechanisms
- treatment of settlements and curtailments

6 The aim is to issue an interim standard that would significantly improve pension accounting by 2010. This paper discusses the impact of that project on the issues raised with the IFRIC.

7 The issues were grouped as follows:

a. Group 1 issues are those that have practical and widespread relevance and where there is significant divergence in practice. Additionally, the IFRIC has already started or is about to start its deliberations on these issues. As a result, a significant amount of staff analysis has already been done and it would be an efficient use of resources for IFRIC to continue its deliberations in these areas.

b. Group 2 issues are those that have fairly widespread relevance and where there is, or could be, significant divergence in practice. They are issues of a high priority, although the impact of them is expected to be less significant than it would be for a Group 1 issue. These issues are not currently under deliberation but the Staff proposes that they should be considered by the IFRIC as soon as it is practical to do so.

c. Group 3 issues are those that are either not very widespread, where the divergence in practice is expected to be less significant than for the first two groups or that have failed to meet one or more of the criteria for being taken onto the IFRIC agenda. These issues should either be brought under deliberation when staff resources allow, referred to the Board or taken off the IFRIC agenda with no further action.

8 The nine outstanding employee benefits issues are:

Group 1 Issues

- D9- plans with a promised return on contributions
- Distinction between defined benefit and defined contribution arrangements
- Impact of a minimum funding requirement on the asset ceiling

Group 2 Issues

- Issues related to the non-consolidation model and definition of plan assets

Group 3 Issues

- Pension promises based on performance hurdles
- Changes to a plan caused by government
- Treatment of employee contributions
- Treatment of death-in-service and other risk benefits

New Issue

- Distinction between curtailments and negative past service costs

Categorisation of outstanding issues

9 The staff's rationale for the categorisation going forward of outstanding employee benefits issues is set out below.

D9: Treatment of Employee Benefits with a Promised Return on Contributions or Notional Contributions

10 IFRIC D9: Employee Benefits with a Promised Return on Contributions or Notional Contributions was issued on 8 July 2004. This draft Interpretation addressed how IAS 19 should be applied to a plan that would be a defined contribution plan but for the existence of a minimum return guarantee.

11 The draft Interpretation proposed that these plans should all be classified as defined benefit and, further, that the benefit promise should be split into the components that are dependent on fixed increases and those that are dependent on variable increases. A defined benefit liability should be recognised in respect of the fixed component and an additional liability be recognised to the extent that the liability in respect of the variable component exceeds the defined benefit liability at the balance sheet date.

12 Most respondents to the draft Interpretation agreed that these plans should be treated as defined benefit arrangements. However there was significant disagreement in respect of the scope of the Interpretation and the proposed methodology. Moreover, many respondents believed that the guidance in D9 introduced new accounting and that the issues would be more appropriately addressed as an amendment to IAS 19.

13 Phase one of the Board project will consider the definition of defined benefit and defined contribution arrangements and the accounting for hybrid pension plans such as cash balance plans.

14 The staff recommends that the IFRIC removes this project from its agenda but that the option to restart the project is left open, should the scope of the Board project change or should the expected timescale for the Board project of 4 years be lengthened.

15 Suggested ‘rejection wording’ and some further details in respect of this issue are set out in the appendix.

Distinction between defined benefit and defined contribution plans

16 The comment letters to D9 indicated that there is widespread confusion in respect of the distinction between defined benefit (DB) and defined contribution (DC) plans.

17 Treating a plan that should be DB as DC would lead to significant divergences. This issue extends to cash balance plans in the US, the TFR in Italy and career average type plans in other parts of the world. The IFRIC has already indicated some agreement on this issue - in particular the IFRIC has noted that all plans where the employer retained some downside risk are defined benefit plans. However, the confusion in practice usually centres around whether or not the risk exists, either because it is possible to describe some plans as both DB and DC or because there is confusion in respect of the employer’s constructive obligation.

18 The staff notes that phase one of the Board project includes consideration of the distinction between defined benefit and defined contribution arrangements. Therefore, consistent with the decision on D9, the staff recommends that this project is removed from IFRIC’s agenda with a view to restarting it should the scope of the Board project change or should the expected timescale be lengthened.

Impact of a minimum funding requirement on the asset ceiling

19 This issue addresses the question: *How should the asset ceiling be applied where regulatory minimum funding requirements have not been met?* In particular, it is not clear whether any such requirements should be taken into account in the determination of the extent to which a refund from the plan or a reduction in future employer contributions can be taken, or in the calculation of the defined benefit obligation (DBO).

20 The IFRIC issued a draft Interpretation, IFRIC D19 IAS 19—The Asset Ceiling: Availability of Economic Benefits and Minimum Funding Requirements on 24 August 2006. The proposals clarify how to determine, in normal circumstances, the limit on the asset that an employer's balance sheet may contain in respect of its pension plan as well as how the pensions asset or liability may be affected when there is a statutory or contractual minimum funding requirement. The comment period ends on 30 October 2006 and the staff expects to bring a preliminary comment analysis to the January IFRIC meeting. This issue is unaffected by phase one of the Board project.

Issues related to the non-consolidation model and definition of plan assets

21 IAS 19 does not require the consolidation of employee benefit plans. It brings qualifying plan assets onto the entity's balance sheet by netting the plan assets at fair value against the sponsor's obligations. Further, SIC 12, which concerns the consolidation of special purpose entities, excludes post-employment benefit plans from its scope.

22 The issues that arise as a result of this include how to treat assets that do not fall within the definition of plan assets and some perceived anomalies relating to the treatment of assets in the individual financial statements of group entities and their treatment in the consolidated financial statements of the group.

23 Overall, the issue could result in divergent practice and the staff has assigned it to Group 2. The issue is unaffected by phase one of the Board project.

Changes to a plan caused by a government

24 The question raised here concerns the treatment of a plan amendment that occurs because of a change made by government. The options under IAS 19 are to include the impact of the change as an actuarial gain or loss or as a past service cost.

25 There have been a few cases, two most recently, where the impact of changes made by government are treated differently. For instance, recently the Comité d'Urgence in France concluded that a change in retirement age caused by government should be treated as a plan amendment giving rise to a past service cost under IAS 19. On a different issue, the FASB concluded that the introduction of a subsidy for employers for Medicare payments to employees should be treated as an actuarial gain or loss. It is not clear, at this stage, whether the two interpretations are truly divergent as they relate to different issues. Some staff believe, in the absence of evidence to the contrary, that the two changes were treated appropriately.

26 However, there may be a broader question in practice regarding whether changes made by a government should be automatically included in actuarial gains and losses or as a past service cost (or credit), or whether the treatment of any change in the plan is independent of whether the change is chosen voluntarily by the company or is imposed by the government. Past service costs and actuarial gains and losses are governed by different recognition rules under IAS 19 (and FAS 87), so the difference in classification will give rise to different accounting. Phase one of the Board project may eliminate the different accounting, but not for four years.

27 This issue could lead to diversity in practice and the impact could be material. However, as the issue is not very widespread it was assigned to the priority group 3. The staff recommends that this issue remains in Group 3.

Pension promises based on performance hurdles

28 This issue is concerned with the classification and measurement of the defined benefit obligation in respect of pension promises based on a performance hurdle. For instance, it would include plans that promise varying levels of contributions linked to the employee's performance or to the company's performance (or both). Further, if the plan is a defined benefit plan, it is not clear what allowance should be made for the performance hurdle, if any, in the calculation of the defined benefit obligation.

29 The staff notes that plans with such pension promises are likely to be in the scope of the part of phase one of the Board project dealing with intermediate risk plans. Therefore the staff recommends that it should keep a watching brief on the scope of the Board project with a view to asking the IFRIC to reconsider whether it wished to remove this item from its agenda. In the meantime, the staff recommends that this issue is included in Group 3.

Treatment of employee contributions

30 The question raised here concerns the inclusion of any employee contributions in the measurement of the defined benefit obligation or the service cost for a plan. IAS 19, like the equivalent standards under UK and US GAAP, is silent on this issue.

31 There are many plans in which the employee makes contributions. In measuring the defined benefit obligation, these contributions are usually ignored. However, it has been suggested to the staff that the present value of future contributions may be deducted from the defined benefit obligation or that the value of future contributions may be treated as a future reimbursement asset to the entity. Similarly, in practice, employee contributions may be included or excluded from the service cost.

32 There appears to be some degree of consensus in practice in respect of this. In general, no allowance is made for future employee contributions in determining the defined benefit obligation and the service cost disclosed is the service cost to the employer after deducting future employee contributions for the period.

33 There is less diversity in practice than for the issues raised above and in many cases the impact of employee contributions may be small. This issue is not affected by phase one of the Board project. When staff resources allow, a full analysis of this issue and subsequent clarification would be useful. In the meantime, this issue has been assigned to priority group 3.

Treatment of death in service and other risk benefits

34 This issue is primarily concerned with the way in which disability and death in service lump sum and pension benefits should be taken into account in the valuation of the defined benefit obligation and service cost for a plan.

35 IAS19 requires the use of the Projected Unit method to value the defined benefit obligation and service cost. However, there are different interpretations of the Projected Unit method in respect of benefits that are not related to service – e.g. death in service and disability pension and lump sum benefits. The approach commonly used for plans in the UK is different from that used in the US (where the attribution method is stipulated under FAS 87) and parts of Europe. The differences depend on whether or not the benefits are insured and in the way in which the insured and uninsured portions are attributed to periods of service.

36 There could be considerable divergence in respect of the treatment of these benefits. However, the difference in approaches is likely to be less material compared with the issues raised above.

37 This issue will be unaffected by phase one of the Board project and the staff recommends that the issue remains in priority group 3.

Curtailments and negative past service costs

38 The IFRIC has received a formal agenda request for the basis for distinguishing between negative past service costs and curtailments to be clarified.

39 It is becoming increasingly common for entities to reduce post employment benefits, for both past and future service. Also, many entities have substantial unrecognised losses due to adverse experience compared to expectations over recent years. Ambiguity in the definitions of a negative past service cost and a curtailment mean that entities can, in effect, choose how to treat any negative plan amendments. One choice would boost current year profit and loss, while the other would result in a stable credit to profit and loss over the remaining vesting period, if any, of the new benefit.

40 Also, the difference in treatment could have a significant impact on first time adoption as the exception provided in IFRS 1 relates only to unrecognised gains and losses, it does not apply to unrecognised past service cost.

41 This could lead to diversity in practice and the impact could be material. Therefore the staff recommends that this issue should be categorised as a Group 2 issue and should be dealt with as soon as possible.

42 The staff notes that phase one of the Board project will consider the recognition of actuarial gains and losses and unvested past service costs. If the Board recommends that all actuarial gains and losses and unvested past service costs are recognised immediately, there would be no difference in the accounting treatment of a negative past service cost or a curtailment. In both cases the change in the present value of the defined benefit obligation would be recognised in profit and loss. However the Board project is not expected to be completed for another four years.

43 In the meantime, the staff believes that it may be possible for the IFRIC to come to a consensus reasonably quickly on how to distinguish between curtailments and negative past service costs. Therefore the staff recommends that the IFRIC include this issue on its agenda. If the IFRIC agrees, the staff hopes to be able to bring a paper on the relevant issues to the next meeting.

Summary of Prioritisation

44 A summary of the suggested prioritisation of the outstanding issues is set out below:

Group 1 - Active Issues

- Impact of a minimum funding requirement on the asset ceiling

Group 2 – Issues pending deliberation

- Curtailments and negative past service costs
- Issues related to the non-consolidation model and definition of plan assets

Group 3 – Issues to be completed when staff resources allow

- Pension promises based on performance hurdles
- Changes to a plan caused by government
- Treatment of employee contributions in the measurement of the DBO and service cost
- Treatment of death-in-service and other risk benefits

Group 4 – Issues to be incorporated as part of the Board project on employee benefits

- D9: *Treatment of Employee Benefits with a Promised Return on Contributions or Notional Contributions*
- DB/DC distinction

45 The Staff would welcome the IFRIC’s views on the suggested order of priorities and the proposed wording for the removal of D9 and the DB/DC distinction projects from the IFRIC’s agenda.

D9: *Employee Benefits with a Promised Return on Contributions or Notional Contributions*

1 Most respondents to the draft Interpretation agreed that D9 plans should be treated as defined benefit arrangements. However there was significant disagreement in respect of the scope of the Interpretation and the proposed methodology. Moreover, many respondents believed that the guidance in D9 introduced new accounting and that the issues would be more appropriately addressed as an amendment to IAS 19.

2 A number of other issues were also raised in respect of the definitions, treatment of gains and losses, in particular, the application of the corridor, transition requirements, definitions and the examples put forward.

Scope

3 At the October IASB meeting, the Board considered the wide range of plans which are neither final salary plans nor pure defined contribution plans. As explained below, these plans vary greatly in the nature of risk and the way in which the risks are shared.

4 According to a research report commissioned by the Department of Work and Pensions into hybrid and risk sharing plans, the main types of plan designs worldwide are:

a. Cash balance plans (typically the amount in the member's account is not directly related to the returns achieved on the underlying assets, but it may be guaranteed or smoothed). (26% of plans in the US and growing).

b. Career Average Plans or Career Average Revalued Plans (75% of pension plan members in the Netherlands. The employees are exposed to conditional indexation risk).

c. Sequential hybrids, where the member may join a DB plan after a period of DC membership (increasingly used as an interim design in the transition away from final salary).

d. Combination hybrids where the member may accrue both DB and DC benefits (Most plans in Switzerland).

e. Self-annuitising plans where the plan offers an in-house annuity option (very common).

f. Underpin arrangements where the benefit is calculated as the better of a DB or DC benefit.

The draft Interpretation deals with only some of these plans.

Measurement

5 A significant number of constituents disagreed with the detailed requirements of the proposed calculation methods.

6 The main issues that have arisen in respect of the measurement of the obligation are:

- the value of any embedded guarantees/options is measured at their intrinsic value;
- the distinction between fixed and variable components is unclear and the draft is silent on the measurement of some variable components.

7 Also, some believed that the proposals are inconsistent with the standard as it effectively:

a. requires a different methodology than prescribed for defined benefit plans;
b. requires a different methodology for the elements of profit and loss;
c. is inconsistent with the approach for DC plans and leads to anomalous results.

8 Some respondents also noted that currently, practice is evolving to use more sophisticated valuation methods to measure the value of embedded guarantees than set out in the draft Interpretation. Respondents were concerned that the adoption of D9 would preclude methods that gave a more faithful representation of the entity's obligation.

Is this a Board project?

9 As a result of the comments above in respect of the scope and measurement methodology, many constituents believed that the accounting for D9 and similar plans should properly be conducted as part of a Board project. Ernst and Young argued that the proposals lead to the:

- *blurring of the distinction between standard setting and the work of the IFRIC,*
- *introduces a fundamental change to IAS 19 in advance of the intended comprehensive review of pensions accounting; and*
- *increases the complexity of an already complicated standard to the extent that it fails to meet the 'understandability' criterion in the IASB's Framework.*

10 USB stated:

> *We have several concerns with the proposed IFRIC Interpretation. We believe that the draft Interpretation does not interpret existing accounting standards, but introduces new accounting which we believe is outside the scope of IFRIC. Any new accounting should go through the proper due process*

11 Treuhand-Kammer

> *encouraged the IASB to reconsider pension accounting in its entirety, including the use of defined benefit accounting for [D9 plans], which are essentially defined contribution plans with a guarantee*.

Options available to the IFRIC

12 The IFRIC has three main options available.

- Finalise the Interpretation
- Revise the Interpretation and re-expose for comment
- Cease further work on the project in light of its inclusion in the Board project

13 As significant concerns were raised in respect of the proposals, the staff does not recommend that the IFRIC proceeds with the finalisation of the Interpretation without further deliberation.

14 The IFRIC could consider revising the draft Interpretation to address the concerns raised by the respondents.

15 [Paragraph omitted from Observer Notes].

16 In light of the Board project, [however], the staff recommends that the IFRIC removes this project from its agenda but that the option to restart the project is left open, should the scope of the Board project change or should the expected timescale for the Board project of 4 years be extended. Proposed ‘rejection’ wording is set out below.

PROPOSED ‘REJECTION’ WORDING

IFRIC D9: *Employee Benefits with a Promised Return on Contributions or Notional Contributions* was issued on 8 July 2004. This draft Interpretation addressed how IAS 19 should be applied to a plan that would be a defined contribution plan but for the existence of a minimum return guarantee.

The draft Interpretation proposed that these plans should be classified as defined benefit and, further, that the benefit promise be split into the components that are dependent on fixed increases and those that are dependent on variable increases. A defined benefit liability would be recognised in respect of the fixed component and an additional liability be recognised to the extent that the liability in respect of the variable component exceeds the defined benefit liability at the balance sheet date.

Most respondents to the draft Interpretation agreed that D9 plans should be treated as defined benefit arrangements. Some respondents agreed with the proposals. However there was significant disagreement in respect of the scope of the Interpretation and the proposed methodology. Some respondents also asked for further clarification of the distinction between defined benefit and defined contribution plans. A significant number of constituents believed that the issues would be more appropriately addressed as an amendment to the Standard rather than as an Interpretation.

The IASB has recently added an active project to its agenda on post-employment benefits. Phase one of the project includes the accounting for intermediate risk plans (including cash balance plans) and the definition of defined benefit and defined contribution plans. Phase one is expected to result in a standard within four years.

The IFRIC considered whether it should proceed with its proposals [but concluded] that the concerns raised by respondents and the project undertaken by the Board meant that this would not be an appropriate use of IFRIC resources. The IFRIC also noted that the work it has completed to date will inform the Board’s progress on its project and that, in the intervening period before the interim standard is finalised, the proposals set out in D9 may provide useful guidance for the accounting for certain types of arrangements.

Therefore [the IFRIC decided] to remove this project from its agenda but to keep a close watching brief on the progress of the IASB project with a view to reviewing this decision if necessary.