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International Accounting Standards Board

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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: **January 2007, London**

Project: **IAS 19 – Curtailments and negative past service cost (Agenda Paper 5)**

Introduction

1. The IFRIC has received a request for an Interpretation giving guidance on whether plan amendments that reduce benefits are accounted for as curtailments or as negative past service costs.

Existing literature

2. The definitions in IAS 19 are as follows:

> **Past service cost**
>
> "…the increase in the present value of the defined benefit obligation for employee service in prior periods, resulting in the current period from the introduction of, or changes to, post-employment benefits or other long-term employee benefits." (paragraph 7)
>
> In addition, IAS 19 notes that past service cost:
>
> - "…may be either positive (where benefits are introduced or improved) or

negative (where existing benefits are reduced).” (paragraph 7); and • “excludes … the effect of plan amendments that reduce benefits for future service (a curtailment).” (paragraph 98)
Curtailment “A curtailment occurs when an entity either: (a) is demonstrably committed to make a material reduction in the number of employees covered by a plan; or (b) amends the terms of a defined benefit plan such that a material element of future service by current employees will no longer qualify for benefits, or will qualify for only reduced benefits. (paragraph 111).

3. The Basis for Conclusions to IAS 19[1] notes:

(a) the old IAS 19 appeared to treat plan amendments that reduce benefits as negative past service cost.

(b) E54, the ED preceding the current version of IAS 19, proposed that amendments that reduce benefits for future service are either curtailments (if the amendment reduces benefits for future service) or settlements (if the amendment reduces benefits for past services).

(c) some commentators on E54 argued that such negative plan amendments should be treated as negative past service cost because they reduce employee morale in the same way that ‘positive’ plan amendments increase morale.

(d) the [IASC] Board decided to treat both ‘positive’ and ‘negative’ plan amendments in the same way.

4. The Basis also notes that “the distinction between negative past service cost and curtailments is unlikely to have any significant effect in practice and that any attempt to deal with exceptional cases would result in excessive complexity.” (paragraph BC62).

[1] Paragraphs 60-62

The issue

5. The constituent raising the issue notes that IAS 19 plan amendments which reduce existing benefits may fall within the definition of either curtailments or negative past service costs. The constituent describes three possible views being taken. These are set out below.

View A

6. Any plan amendment should be considered in its entirety. If an impact of the amendment is to reduce the benefits for future service then the amendment meets the definition of a curtailment. IAS 19.98(e) excludes the impact of curtailments from the definition of past service cost. Therefore the full impact of any plan amendment which reduces benefits for future (and past) service should be accounted for as a curtailment.

View B

7. Follow view A but apply this at the individual member level rather than for the plan as a whole. Therefore the impact for any retiree, terminated, or active member who has passed the date when further service leads to no material amount of further benefits (as specified in IAS 19.67(b)) should be accounted for as a negative past service cost whilst the impact for other active members should be accounted for as a curtailment.

View C

8. The reference in IAS 19.98(e) should be read as excluding only future service impact when considering a curtailment. Therefore the impact of any plan amendment should be broken down into elements which relate to past service (eg accrual rate) and elements which are dependent on future service (eg the impact of future salary increases included in the defined benefit obligation or the impact on the calculation of the defined benefit obligation of straight lining a benefit accrual which includes a back end load in accordance with IAS 19.67). Having bifurcated the plan amendment into mutually exclusive past and future service elements, negative past service cost or curtailment accounting treatment is applied for the respective elements.

Staff recommendation

9. The staff recommends that the IFRIC take a project onto its agenda with a view to issuing an Interpretation supporting View A.

Preliminary analysis

Examples

10. The staff's understanding of Views A-C in paragraphs 6-8 is illustrated in the following examples.

> **Example 1**
>
> An entity operates a defined benefit plan in which employees accrue 1% of their final salary for each year of service. The entity amends the plan so that the employees only accrue 1% of their *current* salary for each year of service (ie a career-average plan). The defined benefit obligation decreases.

11. View A would consider the plan amendment in its entirety. As the plan amendment would result in future service by current employees qualifying for reduced benefits, the plan amendment is a curtailment. The reduction in the defined benefit obligation is accounted for as a curtailment.

12. View B is similar to View A, except that it is applied at the member level. Thus, the accounting would depend on the profile of active and inactive members in the plan. If part of the reduction in the defined benefit obligation relates to active plan members, then that part would be accounted for as a curtailment. The remaining reduction that relates to plan members who are retired, terminated, or past the date when further service leads to no material amount of further benefits would be accounted for as negative past service costs.

13. In View C, the impact of the plan amendment is broken down into elements which relate to past service and elements which are dependent on future service. In this example, all the change in defined benefit obligation arises because benefits now accrue based on the employees' current salaries, rather than their final salaries. View C regards the reduction from salary at the date of the plan amendment to past salary as relating to past service, and the reduction from expected final salary to salary at the date of the plan amendment as relating to

future service.[2] As a result, View C would result in accounting for the decrease in the defined benefit obligation as part past service cost and part curtailment.

Example 2
An entity operated a defined benefit final salary plan in which employees accrue 1% of their final salary for each year of service. The entity amends the plan so that the employees only accrue 0.75% of their final salary for each year of service. The defined benefit obligation decreases.

14. As the plan amendment would result in future service by current employees qualifying only for reduced benefits, View A would treat the plan amendment as a curtailment. The reduction in the defined benefit obligation is accounted for as a curtailment.

15. As in paragraph 12, the accounting in view B would depend on the profile of active and inactive members in the plan. Curtailment and negative past service cost accounting would be applied separately to each group of employees.

16. In View C, the change in accrual rate is treated as relating to past service. The plan amendment is treated as negative past service cost.

Example 3
An entity operated a defined benefit final salary plan in which employees accrue 1% of their final salary for each year of service. The entity amends the plan so that employees would no longer accrue benefits for future years of service. However, the benefits on retirement arising from years of service before the plan amendment would continue be 1% of final salary. There is no change to the defined benefit obligation.

17. In this example, future service by current employees will no longer qualify for benefits. There is no change to the defined benefit obligation as benefits arising

[2] For example, consider an employee who earned 100 on joining the entity, earns 300 at the date of plan amendment and expects that his salary at retirement will be 450. View C would split the reduction in the accrual for the first year of service into (i) an amount based on 200 (=300-100) which would be attributed to past service and (ii) an amount based on 150 (=450-300) which would be attributed to future service.

from past years of service are unaffected. The plan amendment is accounted for as a curtailment in all three views.

Comments on the alternative views

18. We make the following initial observations on the alternative views:

(a) In the staff's view, View A is consistent with IAS 19. However, View A appears to treat all plan amendments that reduce benefits for any future service as curtailments. It is not clear what would remain to be treated as negative past service costs.[3] We believe that IAS 19 would not include the concept of negative past service costs if there were no situations in which it would apply. However, View A is the simplest of the three views. It also maximises the amount of any reduction in defined benefit obligation that is accounted for as a curtailment. In the staff's view, curtailment accounting is superior to past service cost accounting because it does not result in the deferred recognition of amounts over the remaining service lives of current employees.

(b) View B is also consistent with IAS 19. However, unlike View A, View B would treat as negative past service costs the effect of the plan amendment on those employees who are no longer active.

(c) The staff notes that KPMG's "Insights into IFRS" 3rd Edition states:

> "The definition of past service costs excludes plan amendments that impact future service. Therefore if an entity amends the terms of a defined benefit plan such that it affects entitlements from both past as well as future services for the same group of employees, then in our view the plan amendment is accounted for as a curtailment in its entirety. A plan amendment falls under negative past service accounting […] if it affects only the entitlements from past service." (paragraph 4.4.890.50)

In the staff's view, the KPMG view could be read either as being consistent with View A (because it refers to accounting for the plan amendment in its

[3] The only circumstances that the staff can think of in which View A would result in negative past service costs is the unlikely case in which the entity reduces benefits for past service but continues to offer the same level of benefit for future service.

entirety) or View B (because it suggests that the plan amendment be analysed at the level of a group of employees).

(d) Some have suggested that only Views A and B are legitimate interpretations of IAS 19. They would accept diversity between Views A and B, given the Board's project on post-retirement benefits (see paragraphs 29 and 30).

(e) Others argue that Views A and B conflict with the definition of a liability in the Framework and in IAS 37. In their view this arises from a fundamental flaw in IAS 19.

(f) View C attributes the effect of future salary increases to future service. Some staff argue that View C is the only view that divides the change in defined benefit obligation into a component that relates to future service and one that relates to the past. Those staff would argue that View C is the only view that would interpret the curtailments described in paragraph IAS 19.111(b) as affecting the measurement of the defined benefit obligation. As a result, those staff argue that View C is the view that the IASC intended.

(g) Other staff argue that View C is inconsistent with the attribution of benefits to years of service. This is because View C would characterise the uplift in future salaries that accrues each year as resulting from future service. Thus, View C extracts elements of future service from benefits that have already been attributed to the past. Staff holding this view argue that employees' service in past years was rendered in return for benefits whose value includes the effect of expected salary uplifts. As a result, benefits attributed to past years of service, including amounts accrued based on an expected future salary, relate to the past and any changes in those benefits are negative past service costs. In addition, those staff would argue that View C contradicts the statement in paragraph 97 that "past service cost is measured as the change in the liability resulting from the amendment".

US GAAP

19. The staff notes that the concept of negative past service costs was taken from US GAAP and introduced to IAS 19 in response to comments received on E54. The staff notes that the treatment of curtailments and past service cost is different in US GAAP from IFRSs. This paper considers only the definitions.

20. The definitions in US standards FAS 87, “Employers’ Accounting for Pensions” and FAS 88 “Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits” are as follows:

Prior service cost “The cost of retroactive benefits granted in a plan amendment.” (FAS 87) Retroactive benefits are defined as: “Benefits granted in a plan amendment (or initiation) that are attributed by the pension benefit formula to employee services rendered in periods prior to the amendment. The cost of retroactive benefits is referred to as prior service cost.” (FAS 87) FAS 87 also states: “A plan amendment can reduce, rather than increase, the projected benefit obligation.” (FAS 87.28)
Curtailment “An event that significantly reduces the expected years of future service of present employees or eliminates for a significant number of employees the accrual of defined benefits for some or all of their future services.” (FAS 87 and FAS 88)

21. Thus, plan amendments are curtailments in US GAAP only if the *eliminate* the accrual of defined benefits for future service. In contrast, IFRSs require only that benefits are *reduced*. US GAAP does not share the ambiguity in IFRS that arises for amendments that reduce benefits and no analogy can be drawn.

22. The staff believes that US GAAP would treat the three examples in paragraphs 10-17 as negative past service costs because none of those examples *eliminates* employee benefits.

CONSIDERATION OF WHETHER THE IFRIC SHOULD TAKE THE ISSUE ONTO ITS AGENDA

Significantly divergent interpretations

23. The ambiguity in the definitions of a negative past service cost and a curtailment means that entities can, in effect, choose how to treat any plan amendments that reduce benefits. Due to the different accounting treatments of

curtailments (recognised when the curtailment occurs, triggers recognition of unrecognised gains and losses) and negative past service cost (spread over remaining service lives), one choice would boost current year profit and loss, while the other would result in a stable credit to profit and loss over a number of years.

24. Agenda Committee members noted that there is diversity in practice and concluded that the IFRIC should discuss this issue as it was not immediately apparent which of the views described should be pursued.

Practical and widespread relevance

25. The request notes that paragraph BC62 of IAS 19 indicates that the Board anticipated difficulties in providing clear guidance regarding the distinction between a curtailment and a negative past service costs, and that the distinction was unlikely to result in significant variation in results.

26. However, the request notes that improvements in longevity and other adverse experience for post employment benefits in many territories have made it increasingly common to reduce such benefits, in respect of both past and future service. Thus, the conditions described in paragraph BC62 are less rare than originally envisaged by the Board and the issue has become more widespread and of greater relevance. The staff has also received informal correspondence that indicates this issue arises frequently in practice.

27. The IFRIC potential agenda item request notes that the distinction between negative past service cost and curtailments also has a potentially significant impact on first time adoption. The exception provided in IFRS 1 relates only to unrecognised gains and losses, it does not apply to unrecognised past service cost, positive or negative.

28. The Agenda Committee noted that this issue is of widespread and practical relevance.

Relationship with a Board project

29. In July 2006, the Board added a two-phase project on post-employment benefits to its agenda. In November 2006, the Board decided to propose immediate recognition of all past service cost in profit or loss. Although this decision does not eliminate the ambiguity between the definitions of a negative past service

cost and a curtailment, it removes any difference in accounting for them because:

(a) there would be no unrecognised actuarial gains or losses or unrecognised past service cost to be recognised when there was a curtailment.

(b) gains on both negative past service cost and curtailments would be recognised immediately in profit or loss.

30. The staff notes that the first phase of the Board’s post-employment benefits project is likely to resolve the issue. Phase 1 is expected to result in a discussion paper in the summer of 2007, and in final guidance by 2010. Thus, the question is whether the IFRIC should issue an Interpretation to address application difficulties in the short-term.

Likely to result in a consensus of the IFRIC

31. There is no reason why the IFRIC should not be able to reach a consensus on the issue in a reasonable timeframe. If the IFRIC concluded its deliberations at its meeting in March 2007, a draft Interpretation could be exposed for comment in May 2007. A final Interpretation could be achieved by December 2007.

Other avenues open to the IFRIC

32. At its November meeting, the Agenda Committee suggested the staff consider whether this issue would be better resolved by the Board through its annual improvements process. The annual improvements process focuses on areas of inconsistency in standards or where clarification of wording is required. An issue that forms part of the annual improvements might be exposed for comment on 1 October 2007 with amendments effective from 1 January 2009.

33. It would be appropriate to recommend that the Board address this issue as a minor amendment if the IFRIC concluded diversity in practice should be reduced, but that the best way to achieve this would be through a change in the words in the Standard.

34. However, the staff does not recommend this approach because:

(a) the issue arises from an inconsistency in IAS 19 that was noted by the IASC Board in its Basis for Conclusions. Therefore any attempt by the Board to address this issue would go further than clarifying an unintended inconsistency.

(b) any amendment proposed by the Board is likely to be more than "minor" for those plans affected. The annual improvements process is not a suitable vehicle for amendments that are significant.

(c) IAS 19 was finalised in 1998. The Board might question the urgency of any amendment, particularly in the light of its heavy workload and commitment to meet the requirements of its MOU.

(d) the Board has started its short-term project on post-retirement benefits. The Board's tentative decisions so far would reduce the importance of this issue. If the Board is to address the issue, it should be within the existing Board project that would be completed in 2010.

35. The staff believes that the Board is unlikely to be sympathetic to addressing this issue pending its Phase 1 project on post-retirement benefits

Suggested approach

36. The following paragraphs assume that the IFRIC decides to add this item to its agenda.

37. In the staff's view, Views A-C are all legitimate interpretations of IAS 19. Diversity is likely to have occurred since IAS 19 was finalised in 1998. Because of the difference in the definitions of a curtailment in IAS 19 and US GAAP, US GAAP does not provide any insight as to which view is most appropriate.

38. The Board's Phase 1 project on post-employment benefits is expected to eliminate the issue. So an Interpretation is needed only to remove uncertainty and diversity of practice over the next four years. The staff believes that this can be done by the IFRIC choosing to support one of the above views. In the staff's view, View A:

(a) is simple. A plan amendment is either a curtailment or it is not. There is no need to allocate the reduction in defined benefit obligation between past and future service.

(b) would result in curtailment accounting for more reductions in defined benefit obligation. Amounts that arise from curtailment are recognised when the curtailment occurs. Amounts that are negative past service costs are spread over the remaining expected service lives of employees. Thus, View A would result in superior accounting for more plan amendments.

39. The staff recommends that the IFRIC issues an Interpretation along the lines of View A.

Appendix: Definitions and accounting for curtailments and negative past service cost

IAS 19, FAS 87 and FAS 88 – for reference

	IAS 19	**FAS 88/87**
Curtailment definition	A curtailment occurs when an entity either: (a) is demonstrably committed to make a material reduction in the number of employees covered by a plan; or (b) amends the terms of a defined benefit plan such that a material element of future service by current employees will no longer qualify for benefits, or will qualify for only reduced benefits. A curtailment may arise from an isolated event, such as the closing of a plant, discontinuance of an operation or termination or suspension of a plan. An event is material enough to qualify as a curtailment if the recognition of a curtailment gain or loss would have a material effect on the financial statements. Curtailments are often linked with a restructuring. Therefore, an entity accounts for a curtailment at the same time as for a related restructuring. (paragraph 111)	…a curtailment is an event that significantly reduces the expected years of future service of present employees or eliminates for a significant number of employees the accrual of defined benefits for some or all of their future services. Curtailments include: a. Termination of employees' services earlier than expected, which may or may not involve closing a facility or discontinuing a component of an entity b. Termination or suspension of a plan so that employees do not earn additional defined benefits for future services. In the latter situation, future service may be counted toward vesting of benefits accumulated based on past service.
Curtailment accounting	Unrecognised actuarial gains and losses and past service cost added to gain or loss on curtailment and recognised when curtailment occurs	1. Previously unrecognised prior service cost recognised 2. Changes in PBO cancel out any unrecognised gains or losses. 3. If sum of 1 and 2 is a net loss then recognise in earnings when it is probably that a curtailment will occur and the effects described are reasonably estimable. 4. If sum of 1 and 2 is a net gain, then recognise in earnings when the related employees terminate or the plan suspension

		or amendment is adopted.
Negative past service cost definition	"…the increase in the present value of the defined benefit obligation for employee service in prior periods, resulting in the current period from the introduction of, or changes to, post-employment benefits or other long-term employee benefits. Past service cost may be either positive (where benefits are introduced or improved) or negative (where existing benefits are reduced)." (paragraph 7) Paragraph 98 also states "Past service cost excludes …(e) the effect of plan amendments that reduce benefits for future service (a curtailment)." Paragraph 100: where an entity reduces benefits payable under an existing defined benefit plan, the resulting reduction in the defined benefit liability is recognised as (negative) past service cost over the average period until the reduced portion of the benefits becomes vested.	US GAAP does not have the concept of negative past service cost. Prior service cost is defined as "The cost of retroactive benefits granted in a plan amendment." Retroactive benefits are defined as "Benefits granted in a plan amendment (or initiation) that are attributed by the pension benefit formula to employee services rendered in periods prior to the amendment. The cost of retroactive benefits is referred to as prior service cost." However, paragraph 28 notes "A plan amendment can reduce, rather than increase, the projected benefit obligation."
Negative past service cost accounting	Recognised over the average period until the benefits become vested	A plan amendment can reduce, rather than increase, the pension benefit obligation. Such a reduction shall be used to reduce any existing unrecognised prior service cost, and the excess, if any, shall be amortised on the same basis as the cost of benefit increases. [ie amortised over remaining service period.] (paragraph 28)