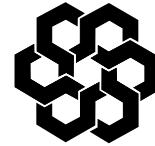

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International Accounting Standards Board

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:	**19 July 2007, London**
Project:	**Post-employment benefits**
Subject:	**Feedback from Employee Working Group Meeting (Agenda paper 7A)**

INTRODUCTION

1. The first meeting of the Employee Benefits Working Group was on 5 June 2007. The working group discussed the following topics:

    a. the Phase 2 project.

    b. elimination of deferred recognition for defined benefit promises.

    c. presentation alternatives, including the 3 approaches previously discussed by the Board.

    d. definitions of benefit promises.

    e. classification of promises with fixed returns.

2. The minutes of the meeting are in Appendix A [not provided in observer notes].

3. This paper identifies issues raised in the meeting that the staff think should be discussed by the Board. These are:

    a. the immediate recognition of unvested past service costs.

b. concerns raised about approach 3 of the presentation alternatives.

c. inclusion of a further presentation alternative.

4. If, on reviewing the minutes for the working group meeting (see Appendix A), any Board member wishes to raise any additional issues for discussion with the Board, we ask that you notify us in advance of the July meeting.

SUMMARY OF STAFF RECOMMENDATIONS

5. The staff recommends that the Board:

   a. confirms that unvested past service cost should be recognised immediately in the period that the plan amendment occurs.

   b. modifies approach 3 for presentation as set out in paragraphs 24 and 25.

   c. does not introduce further presentation alternatives in the discussion paper.

THE IMMEDIATE RECOGNITION OF UNVESTED PAST SERVICE COST

6. The Board decided in November 2006 that all changes in the post-employment defined benefit obligation and in the value of plan assets should be recognised in comprehensive income in the period in which they are incurred. This includes the recognition of unvested past service cost. The section of the November Board papers relating to unvested past service cost is attached in Appendix B.

7. Unvested past service cost arises when an entity introduces a defined benefit plan that attributes unvested benefits to past service, or changes benefits attributed to past service under an existing defined benefit plan.

8. Some working group members questioned whether it was appropriate to recognise unvested past service immediately in the period in which the entity amends a plan. They argued that immediate recognition could lead to a misleading view of employee compensation because entities would report a higher expense in the year of the plan amendment than in the following years when in fact the compensation given to employees is stable.

9. Those working group members argued that entities amend or introduce plans to give compensation to employees in exchange for future services, and not to compensate employees for services already delivered. This is the case even if the terms of the plan amendments or introductions attribute benefits to past service periods. Often, the attribution of benefits to past service is a means of assigning a fixed amount of increased compensation among existing employees.

10. Many working group members noted the importance in phase 1 of not making changes that would be reversed in phase 2. In this context, some working group members expressed their concern that the Board's proposed treatment of unvested past service costs was inconsistent with IFRS 2 and the proposed amendments to IAS 19 relating to the treatment of termination costs. IFRS 2 and the proposed amendments to IAS 19 presume that compensation with a vesting period is in exchange for services to be rendered in the future.

11. The staff and Board shared similar concerns. In previous discussions, the staff and Board noted that immediate recognition of unvested past service cost would lead to a change from current practice under IAS 19, and 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 19.

12. However, the staff continues to argue that 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. In the staff's view, the Board could not require recognition of unvested past service cost over the vesting period, unless it were willing to accept either:

    a. a departure from the general requirement in IAS 19 to attribute benefits to periods of service using the benefit formula (see paragraph 13); or

    b. an exception to immediate recognition of all gains and losses arising from defined benefit post-employment benefit plans (see paragraph 14).

13. Recognition of unvested past service cost over the vesting period could be justified if the Board attributes all unvested past service cost over the vesting period, rather than in accordance with the benefit formula. However, the Board has previously stated that it would not re-examine accounting primarily based on the benefit formula and the measurement of the defined benefit obligation in

phase 1 of this project. It would be more appropriate to address such issues in phase 2.

14. If the Board retained the attribution of benefit in accordance with the benefit formula, then unvested past service cost is a liability in accordance with IAS 19. Recognising unvested past service cost over the vesting period would result in deferred recognition of part of that liability.

15. Finally, recognising unvested past service costs immediately in the period in which it occurs is consistent with the approach in SFAS 158 *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*. SFAS 158 recognises unvested prior service cost in the period of the plan amendment, in other comprehensive income.

16. Accordingly, the staff recommends that the Board confirm that unvested past service cost should be recognised immediately in the period that the plan amendment occurs.

17. The staff notes that this recommendation is inconsistent with IFRS 2. However, the choice is between internal consistency in IAS 19, a model which is recognised as being different from the accounting in other IFRSs, and an inconsistency between IAS 19 and IFRS 2. The staff argues that choosing internal consistency in IAS 19 does not raise fundamental questions about the IAS 19 model and is more important for this phase of the project.

CONCERNS RELATING APPROACH 3 FOR PRESENTATION

18. In March 2007, the Board decided to include in the discussion paper three approaches to the presentation of changes in defined benefit pension plans. Approach 3 proposed that that following components are recognised in profit or loss and other comprehensive income:

Profit or loss	**Other comprehensive income**
• Service cost • Interest cost • Actuarial gains and losses on the defined benefit obligation except those arising from changes in the discount rate • Dividends received on equity plan assets • Interest earned on debt plan assets (using the current rate inherent in the fair value)	• Actuarial gains and losses arising from changes in the discount rate • Changes in the fair value of plan assets other than dividends received and interest earned on plan assets

19. Many working group members supported approach 3 because it recognises remeasurements outside profit or loss, separately from other changes in pension assets and liabilities. However, some working group members expressed reservations about recognising dividends received on equity plan assets in profit or loss, while recognising other changes in the fair value of equity plan assets in other comprehensive income. This means that the returns from income-earning equity investments are recognised separately from the returns from non-income-earning equity investments. As a result, some entities may see an incentive in allocating assets to achieve an accounting result, rather than for economic reasons.[1]

[1] The staff notes that the recognition of an expected return on assets in profit or loss to offset the interest cost could also result in the allocation of assets to achieve an accounting result. Reporting an expected return on assets in profit or loss could favour investment in equities so that entities could report a higher expected return.

20. The staff is sympathetic to this concern. By creating an incentive for entities to make asset allocation decisions based on accounting, rather than economics, approach 3 would result in financial statements that are not neutral.

21. The staff has tried to come up with ways to amend approach 3 that would:

    a. address the concern about asset allocation

    b. preserve the rationale of approach 3 (which is to separate changes that resulted from changes in market interest rates from other changes in estimate)

    c. continue to recognise interest expense on the obligation and a proxy for interest income on equity plan assets in profit or loss. Many constituents regard the offset so provided as being an important economic effect of a funded plan. Those constituents argue that interest cost on defined benefit obligations should be offset by interest income on plan assets because both represent changes in the carrying amount of the plan liability and the plan assets due to the passage of time.

22. The staff proposes that approach 3 is modified so that entities recognise in profit or loss an interest income on plan assets (both equity and debt plan assets) that is calculated by multiplying the plan assets at the beginning of the period by the high quality corporate bond rate used in IAS 19 to discount the liability. That interest income would replace the dividends received on equity plan assets and interest earned on debt plan assets in profit or loss. Such a measure:

    a. provides a proxy for an interest income on plan assets to offset the interest cost recognised in profit or loss.

    b. is easily calculated.

    c. removes subjectivity

    d. would be comparable across entities.

    e. does not create an incentive to manipulate asset allocation.

23. The staff acknowledges that this measure of interest income is arbitrary. However, the staff argues that this is an inherent problem in trying to disaggregate the change in value of plan assets so as to permit an interest offset

in profit or loss without also reporting the total change in the value of plan assets in profit or loss.

24. **Accordingly, the staff recommend that approach 3 is modified so as to recognise in profit or loss:**

    a. **service cost**

    b. **interest cost**

    c. **actuarial gains and losses on the defined benefit obligation except those arising from changes in the discount rate**

    d. **imputed interest income on plan assets determined using the discount rate determined by reference to market yields at the balance sheet date on high quality corporate bonds.**

25. **Entities would recognise actuarial gains and losses arising from changes in the discount rate and changes in the fair value of plan assets other than those in (d) outside profit or loss in other comprehensive income.**

INCLUSION OF A FURTHER PRESENTATION ALTERNATIVE

26. All three approaches for presentation attracted criticism from at least some working group members. In the light of this, some working group members questioned why the Board had not considered including the "FRS 17 option" of presentation that was included in IAS 19 in December 2004. This option permitted an entity to recognise actuarial gains and losses in full in the period in which they had occurred, but presented outside profit or loss in other comprehensive income.

27. Working group members noted that such a presentation approach would not be a long-term solution to presentation, but may be more acceptable to many constituents in phase 1 of the project, pending further progress on presentation principles in the financial statement presentation project.

28. The staff agreed to report this view to the Board.

29. However, on further consideration, the staff notes that the "FRS 17 option" would not be appropriate for inclusion in the discussion paper because it presents an expected return on assets in profit or loss. The actuarial gains or

losses that are presented outside profit or loss include the difference between actual and expected return on assets. Accordingly, because Board has decided to eliminate the requirement to identify an expected return on assets, it cannot include the FRS 17 option as a presentation alternative in the discussion paper.

30. **The staff recommends no action.**