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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IASB Meeting:	**Employee Benefits Working Group**
Paper:	**Agenda Paper 3B - Recognition and Presentation: Elimination of deferred recognition**

1. The Board's preliminary view is that 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 paper describes the Board's reasons for this preliminary view.

2. The Board does not intend to require immediate recognition of changes in post-employment benefit cost without first finding a satisfactory approach to presenting its components. Presentation is discussed in paper 2C.

Changes in plan assets and the defined benefit obligation

3. IAS 19 permits entities to recognise some changes in the value of plan assets and the defined benefit obligation in periods after the period in which they occur. Specifically, IAS 19 permits entities:

   (a) not to recognise actuarial gains and losses that do not exceed the corridor (the greater of 10% of plan assets and 10% of plan liabilities).

(b) to defer recognition of actuarial gains and losses that exceed the corridor. These gains and losses can be recognised over the service lives of the employees.

4. This deferred recognition model in IAS 19 treats changes in defined benefit obligations and plan assets differently from changes in other assets and liabilities. These requirements were developed to accommodate the following views:

   (a) Some argued that post-employment benefit obligations could not be measured as reliably as other items recognised in financial statements because it is impossible to predict accurately for a period (or over several periods) salary levels, length of employee service, mortality, retirement ages and other pertinent events. A revision in the estimate of the obligation in one period need not result from the events of that period and may not reflect changes in the underlying liability. Thus, those holding this view argued that the volatility that could result from reporting period-to-period revisions does not represent faithfully changes in the amount of the post-employment benefit obligation in each period.

   (b) Some argued that period-to-period changes in the value of plan assets and the defined benefit obligation are not relevant to the financial statements. Those holding this view contended the long periods for which plan assets are held gives the opportunity for some gains or losses on plan assets to reverse or offset each other. Similarly, they contend that the long periods before settlement of defined benefit obligations gives the opportunity for changes in estimate that arise in any period to reverse. Thus, they argued that reporting changes in fair value of plan assets or the defined benefit obligation each period results in volatility that is not relevant.

   (c) Some argued that, regardless of whether the volatility resulting from immediate recognition is a faithful representation, it is too great to be acceptable in financial statements. It is not useful to users because it would overwhelm the results and financial position of the business operations. Further, it may cause entities to close their defined benefit plans.

5. When IAS 19 was issued, the IASC recognised the attraction of the immediate recognition approach, but concluded that it was not feasible at that time. IAS 19

was intended as an evolutionary improvement in accounting. However, many years have passed and some constituents argue that a review of the accounting for post-employment benefits, in particular the deferred recognition features, is now necessary to improve the quality and transparency of financial statements. In the light of the Board's progress in related projects such as financial statement presentation, insurance, and IAS 37, the Board concluded that the deferred recognition features of IAS 19 should be reconsidered.

6. The main criticisms of the deferred recognition model are:

   (a) an employer with a defined benefit plan is not required to recognise economic changes in the cost of providing post-employment benefits – the changes in plan assets and benefit obligations – as those changes take place.

   (b) an asset may be recognised when a plan is in deficit or a liability when a plan is in surplus.

   (c) it relegates important information about post-retirement plans to the notes to the financial statements.

   (d) the resulting accounting has a level of complexity that makes it difficult for many financial statement users to understand and adds to the cost of applying IAS 19 by requiring entities to keep complex records.

7. The Board regards these criticisms as cause for serious concern. The Board noted the arguments in paragraph 4 in favour of deferred recognition, but came to the following conclusions.

   (a) The Board rejected arguments that post-employment benefit obligations are more difficult to measure reliably compared to other obligations. Those arguments are based on the observation that most entities do not ordinarily assume obligations of comparable significance that depend on unknown and uncontrollable future events to define the amount that will ultimately be transferred to settle the obligation. The Board noted that the settlement amount of asset retirement obligations and insurance liabilities similarly depend on unknown and uncontrollable future events. The *Framework* acknowledges that items recognised in financial statements may suffer "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". However, it notes "it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement". Accordingly, the Board concluded post-employment benefit costs and obligations can be determined sufficiently reliably to warrant recognition.

(b) The Board noted arguments that possible future offset makes recognising actuarial gains and losses that arise from period-to-period inappropriate. However, the Board concluded that offset was not inevitable, and that it was equally possible that there would be no offset. If the original actuarial assumptions are still valid, future fluctuations will, on average, offset each other and not offset past fluctuations. The Board concluded that the possibility of future offset does not justify non-recognition of actuarial gains or losses.

(c) The Board rejected arguments that volatility resulting from changes in plan assets and post-employment benefits obligations is too great to be acceptable in the financial statements. A financial measure should be volatile if it purports to represent faithfully transactions and other events that are themselves volatile. Similarly, if post-employment plans and the gains and losses arising from them are, in reality, large compared to business operations, the financial statements should reflect that fact. In the Board's view, inappropriate 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.

8. The Board noted that deferred recognition is not a necessary component of the basic measurement model for defined benefit plans in IAS 19. Thus, the Board concluded that it could address deferred recognition without reconsidering the measurement model generally.

9. The Board argues that immediate recognition would be consistent with the *Framework* and other IFRSs. For example:

(a) The *Framework* requires that "the effects of transactions and other events are recognised when they occur [… and] are recorded in the accounting records and reported in the financial statements of the periods to which they relate."

(b) Immediate recognition of actuarial gains and losses is consistent with IAS 8. IAS 8 requires the effect of changes in accounting estimates be included in the period if the change affects the current period only and not future periods.

(c) IAS 37 requires changes in liabilities, including changes in long-term liabilities (such as asset retirement obligations), to be recognised in the period they occur.

10. The Board also argues immediate recognition has the following advantages:

(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. Amounts recognised on the balance sheet meet the definitions of assets or liabilities in the *Framework*.

(b) it results in amounts in the balance sheet and statement of comprehensive income that are transparent and easy to understand. The approach generates income and expense items that provide information about changes in the post-employment benefit plan in that period.

(c) it improves comparability across entities compared to the various options currently in IAS 19.

11. The Board noted that IAS 19 currently permits immediate recognition of all gains and losses, either in profit or loss or in other recognised income and expense. Some entities currently use these options.

12. Accordingly, the Board's preliminary view is that all changes in the value of plan assets and in the post-employment benefit obligation should be recognised in the period in which they occur.

Question 1

The Board's preliminary view is that all changes in the value of plan assets and in the post-employment benefit obligation should be recognised in the period in which they occur. Are there any arguments that the Board has not considered? What are they?

Expected return on assets

13. IAS 19 permits entities to recognise only an expected return on assets in profit or loss. The difference between the actual and expected return on assets forms part of the actuarial gains and losses that are treated as described in paragraph 3.

14. Some users[1] argue that the division of the actual return on plan assets into an expected return and an actuarial gain or loss provides information that is more relevant for users than a single item representing the actual return. Those users argue that identification of an expected return provides the most relevant information for forecasting future investment returns and hence potential cash contributions to the fund. Those users also note that the expected return provides a benchmark against which to measure the entity’s investment performance.

15. However, the Board noted that research from the financial instruments project indicates that other users do not find information about disaggregation of changes in fair value of assets to be decision-useful. Further, the Board noted that subjectivity in determining the expected rate of return provides entities with an opportunity to choose a rate with a view to manipulating profit or loss. The Board noted that there can be large differences between expected and actual returns on assets. The Board concluded there was inherent subjectivity in identifying an expected return on assets. Removing that subjectivity would require complex and arbitrary rules.

16. Accordingly, the Board concluded that the return on assets should not be divided into an expected return and an actuarial gain or loss.

Question 2

Do you agree with the Board’s preliminary view that the return on plan assets should not be divided into an expected return and an actuarial gain or loss? What are your reasons?

Plan amendments

17. Past service costs arise when an entity introduces a defined benefit plan that attributes benefits to past service, or changes benefits attributed to past service under an existing defined benefit plan. IAS 19 characterises past service cost as

[1] Financial Reporting for Investors, UBS, April 2007

increasing the present obligation that arises from employees' past service. Accordingly, IAS 19 requires entities to recognise past service costs from vested benefits immediately, and recognise past service costs from unvested benefits as an expense on a straight-line basis over the average period until the benefits become vested.

18. The treatment of unvested past service costs is consistent with the objective of recognising the cost of post-employment benefits over the expected service period of the related employees. It regards unvested benefits arising from plan amendments as attributable to employee service in future periods, rather than in the past or only in the period of change. This is consistent with other IFRSs, which do not attribute changes in benefits to past service. For example, the treatment of changes in share-based benefits in accordance with IFRS 2 and the proposed treatment of unvested termination benefits as a stay bonus in the July 2005 Exposure Draft of amendments to IAS 19[2] regard increases in benefits with a vesting period as attributable to employees' future services until vesting date.

19. However, the Board also noted that the concept of a present obligation arising from changes in unvested benefits attributed to *past* service is inherent in IAS 19's reliance on the benefit formula to calculate the projected benefit obligation for unvested benefits. It is beyond the scope of Phase 1 of this project to change the calculation of the projected benefit obligation or the reliance on the benefit formula. Thus, the Board concluded that, within the context of Phase 1 of this project, the liability for past service determined in accordance with IAS 19 should be recognised immediately.

20. Accordingly, the Board's preliminary view is that all effects of changes arising from plan amendments should be recognised immediately in the period in which the plan amendment occurred.

Question 3

[2] 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 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."

Do you agree that all effects of changes arising from plan amendments should be recognised immediately in which the plan amendment occurred? If not, when should they be recognised? Why?