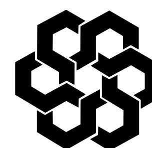
30 Cannon Street, London EC4M 6XH, England
Phone: +44 (0)20 7246 6410, Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org   Website: http://www.iasb.org



International Accounting Standards Board

This document is provided as a convenience to observers at Standards Advisory Council meetings, to assist them in following the Council's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

Note: These notes are based on the staff paper prepared for the Council. Paragraph numbers correspond to paragraph numbers used in the Council paper.

INFORMATION FOR OBSERVERS

SAC Meeting: **June 2007, London**

Project: **Post-employment Benefits**
(Agenda Paper 6)

Introduction

1. At its June 2006 meeting, the SAC received a paper detailing the reasons for adding a project on post-employment benefits to the Board's agenda. The Board started work on this project in October 2006. This paper outlines the Board's tentative decisions on phase 1 of its project on post-employment benefits. The Board has come to tentative decisions on the following topics:

   (a) elimination of deferred recognition in IAS 19

   (b) elimination of the expected return on assets

   (c) presentation of components of defined benefit post-employment benefit costs

   (d) the accounting for cash balance plans.

Elimination of deferred recognition

2. 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.

IAS 19 also requires entities to recognise past service costs from unvested benefits as an expense on a straight-line basis over the average period until the benefits become vested. Past service costs are discussed in paragraphs 13-16.

3. In recent years, many users and academics have criticised the deferred recognition model in IAS 19. The main criticisms 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.

4. 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.

5. In considering arguments generally cited in support of deferred recognition, the Board 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.

6. The Board argues that immediate recognition:

(a) would be consistent with the *Framework* and other IFRSs. For example:

(i) 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."

(ii) 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.

(iii) 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.

(b) has the following advantages:

(i) 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*.

(ii) it results in amounts in the balance sheet and statement of comprehensive income (both in profit or loss and in other 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.

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

7. 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.

8. 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 comprehensive income, either in profit or loss or in other comprehensive income, in the period in which they occur.

Question 1

Do you agree that all changes in the value of plan assets and in the post-employment benefit obligation should be recognised in comprehensive income, either in profit or loss or in other comprehensive income, in the period in which they occur?

Expected return on assets

9. 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 whose recognition may be deferred.

10. 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.

11. 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.

12. 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 that the return on plan assets should not be divided into an expected return and an actuarial gain or loss?

Plan amendments

13. 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 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.

14. 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

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

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.

15. 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.

16. 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

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?

Presentation

17. The Board is currently engaged in a project on financial statement presentation. That project will develop principles for the presentation of the components of comprehensive income. In the light of that project, the Board concluded that it would be premature to express a preliminary view on presentation of the components of pension costs at this stage of the project.

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[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."

18. However, the financial statements presentation project has not yet specifically addressed the presentation and display of components of post-employment benefit cost. The Board decided that the post-employment benefits project provided an opportunity to seek constituent views on how the presentation of post-employment benefit costs could enhance the usefulness of the information provided. To do this, the Board intends the discussion paper to include three approaches to presentation. The three approaches illustrate different ways of providing information about components of post-employment benefit costs.

19. The Board noted that constituents have expressed the following views:

    (a) Some users consider post-employment benefit obligations to be financing in nature. This is because the entities can determine the size of their post-employment benefit obligations through financing-type decisions. Paragraph 16 of the Framework states that "information about financial structure is useful in predicting future borrowing needs and how future profit and cash flows will be distributed among those with an interest in the entity; it is also useful in predicting how successful the entity is likely to be in raising further finance."

    (b) Some constituents argue that some components of changes in post-employment benefit obligations are unusual, abnormal or infrequent, for example, those changes that arise from events outside management control, or those that cannot be classified as operating. The Framework[3] notes that predictive value "is enhanced … by the manner in which information on past transactions and events is displayed". Specifically, "the predictive value of the income statement is enhanced if unusual, abnormal and infrequent items of income or expense are separately disclosed".

    (c) Separate identification of some components of post-employment benefit cost should provide information about variability of the employer's performance. The Framework states this is important to assess potential changes in the economic resources that the entity is likely to control in the future.

20. Whilst not expressing a view on the particular arguments above, the Board believes that distinguishing some components of post-employment benefit costs from others would enhance the relevance of information on the financial statements. Separate disclosure of those components is already required in the notes to the financial statements. The question

[3] Paragraph 28

is whether any distinction should also be reflected in the primary statements, for example by recognising some components of pension cost outside profit or loss.

21. The Board has been told that many constituents are resistant to recognising all changes in defined benefit plans in the period in which they occur because they are concerned that presenting all those changes in profit or loss would not give sufficient prominence to the different nature of some of those changes.

22. While some argue that the Board should not create any more ad hoc exceptions to the recognition of items of income and expense outside profit or loss, others argue that the presentation of some components of changes in post-employment benefit obligations outside profit or loss could address constituent concerns, and would be the best way to improve financial reporting of post-employment benefit plans until the Board makes further progress on financial statements presentation.

23. Those holding this view argue that, in the short-term, the elimination of deferred recognition of gains and losses from post-employment benefits is possible only if the Board considers approaches in which some components of the cost are recognised outside profit or loss. To support their view, they argue that the recent amendments to IAS 1 provide an adequate framework to permit transparent reporting of all post-employment benefit costs because they result in an equal status for all items of income and expense that are recognised in the statement of comprehensive income. Items of income and expense recognised outside profit or loss are part of comprehensive income, and not recognised directly in equity. Thus, there is no conceptual basis to assign a superior status to components displayed in profit or loss, compared to those in other recognised income and expense.

The approaches

24. The three approaches set out below present information about post-employment benefit cost in different ways. They are illustrated numerically in the appendix. Each approach seeks to present information that is useful, drawing on constituents' expressed opinions and views, and discussion from the Board's financial statements presentation project. Two of the approaches present some components of post-employment benefit cost outside profit or loss. The staff would welcome SAC members' views of the advantages or disadvantages of each approach.

Approach 1

25. All changes in the defined benefit obligation and in the value of plan assets are presented in profit or loss in the period in which they are incurred.

Approach 2

26. This approach presents the costs of service in profit or loss. All other costs are reported as consequences of deferring payment of employee remunerations and financing that deferred payment.

27. Accordingly:

    (a) service costs, and the gains and losses associated with them are recognised in profit or loss. Thus, service costs, and actuarial gains and losses on the defined benefit obligation except those arising from changes in the discount rate would be recognised in profit or loss.

    (b) all other changes are recognised outside profit or loss. This includes interest cost, changes in the discount rate and all changes in plan assets.

Approach 3

28. This approach presents changes arising from changes in financial assumptions outside profit or loss. Thus, changes in the computed "price" of the pension obligation and fair value of plan assets are recognised outside profit or loss.

29. Accordingly, profit or loss would include:

    (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) dividends received on plan assets, and

    (e) interest earned on plan assets (using the current rate inherent in the fair value).

30. The Board does not intend to conclude which is the most appropriate approach in the discussion paper. The Board intends to include the three approaches and the arguments for and against them in the discussion paper to give a complete analysis of the approaches and to obtain a variety of constituent views.

Question 4

What information about the components of defined benefit costs is useful? What are the advantages or disadvantages of each of the alternative approaches?

Cash balance plans

31. For some time, typical defined benefit and defined contribution plans were very common. However, during the 1980's and 1990's there was a significant shift away from typical defined benefit and defined contribution plans to plans that have features of both, as well as new features, such as guarantees. These plans are known as cash balance plans. In a typical cash balance plan, an employer promises the employee both a contribution for each year of service and a specified return on accumulated contributions.

32. Constituents raised the accounting for cash balance plans with the IFRIC because of significant problems and diversity in practice. The IFRIC's deliberations led to the publication of Exposure Draft D9 *Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions.* However, the IFRIC's work was superseded by the Board's decision to address cash balance plans as part of Phase 1.

33. The Board noted that the IFRIC is not best placed to deal with the accounting for cash balance plans because the requirements of IAS 19 were not designed with such plans in mind and are not always appropriate. This paper does not discuss the difficulties in applying IAS 19 to cash balance plans, but further information can be obtained from the Board's website at http://www.iasb.org/Current+Projects/IASB+Projects/Post-retirement+Benefits+%28including+Pensions%29/Meeting+Summaries+and+Observer+Notes/IASB+October+2006.htm.

34. The Board seeks to develop guidance on accounting for cash balance plans without fundamental changes to the accounting model in IAS 19. In particular, the Board does not intend to revise the accounting for typical defined contribution or defined benefit plans.

35. The Board has characterised cash balance plans as those in which the benefit promise comprises both contributions and a specified return on contributions. It proposes that these promises are named "defined return" promises. The Board proposes revised definitions to identify defined return promises and to distinguish them clearly from defined benefit and defined contribution promises.

36. The Board's tentative decisions so far are:

(a) Post-employment benefit plans are composed of *defined benefit*, *defined contribution* and *defined return* promises. Some plans may have one or more promise.

(b) Defined contribution, defined return and defined benefit promises are defined as follows:

(i) A defined contribution promise obliges the employer to pay specified contributions to a separate entity (a fund). Payment by the employer of those specified contributions extinguishes the obligation.

(ii) A defined return promise is comprised of a contribution requirement and a promised return on those contributions.

The contribution requirement obliges the employer to pay specified actual or notional contributions to an actual or notional fund. Payment by the employer of those specified contributions extinguishes that obligation.

The promised return component obliges the employer to provide a defined return on the specified contributions. That defined return is linked to the change in an asset or index.

(iii)All other promises are defined benefit. Typically, defined benefit promises change in line with service or salary or include demographic risks to the employer while the benefit is in payment.

(c) Promises with fixed increases meet the definition of a defined return promise.

(d) Current salary and full career average promises are defined return promises, ie promises that can be expressed wholly in current salary terms without an additional salary-related component are defined return promises. Other salary-related promises are defined benefit promises.

(e) Defined benefit and defined contribution promises should be accounted for in accordance with the current IAS 19 accounting requirements for defined benefit and defined contribution plans respectively.

(f) The liability for unpaid contributions in a defined return promise should be measured at the sum of the accumulated unpaid contributions whether the plan is funded or unfunded.

(g) The employer’s liability for the promised return component in a defined return promise is measured as the fair value of the promised return less any plan assets available to satisfy that liability.

37. The Board will continue its discussions on defined return promises at its June meeting.

Question 5

Do you agree with the characterisation of the “problem plans” and the definitions of defined contribution, defined return and defined benefit?

Question 6

Do you agree with the approach for the measurement of defined return promises?

Appendix

Amounts recognised in the balance sheet, profit or loss and statement of recognised income and expense

This appendix illustrates how a simple example might be presented in each of the approaches described in paragraphs 26-31. Disaggregation of items in profit or loss and in the statement of recognised income and expense has not yet been discussed.

	Approach 1		Approach 2		Approach 3	
Profit or loss	20x1	20x2	20x1	20x2	20x1	20x2
Current service cost	130	140	130	140	130	140
Interest cost	60	62			60	62
Return on plan assets (total)	- 131	- 112				
Return on plan assets						
- dividends and interest income					- 41	- 12
Actuarial gains and losses on obligation						
- arising from effect of change in discount rate	159	190				
- other actuarial gains and losses on the obligation	- 98	- 197	- 98	- 197	- 98	- 197
Expense recognised in profit or loss	120	83	32	- 57	51	- 7
Statement of recognised income and expense						
Interest cost			60	62		
Return on plan assets (total)			- 131	- 112		
Return on plan assets						
- changes in fair value other than dividends and interest income					- 90	- 100
Actuarial gains and losses on obligation						
- arising from effect of change in discount rate			159	190	159	190
Other recognised income and expense	0	0	88	140	69	90
Expense recognised in profit or loss for period	120	83	32	- 57	51	- 7
Total recognised income and expense for the period	120	83	120	83	120	83

Assumptions

All transactions are assumed to occur at the year-end.

Present value of obligation	20x1	20x2
Present value of obligation, 1 January	1,000	1,101
Interest cost	60	62
Current service cost	130	140
Benefits paid	- 150	- 180
Effect of change in discount rate (estimated)	159	190
Actuarial (gain) loss for year - obligation	- 98	- 197
Present value of obligation, 31 December	1,101	1,116

Fair value plan assets	20x1	20x2
Fair value of plan assets, 1 January	1,000	1,056
Contributions received	75	85
Benefits paid	- 150	- 180
Dividends and interest income	41	12
Change in fair value of plan assets	90	100
Fair value of plan assets, 31 December	1,056	1,073
Net pension liability	45	43