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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**February 2008, London**
Project:	**ED Annual Improvements Process**
Subject:	**IAS 19 *Employee Benefits* Comment Letter Analysis curtailments and negative past service cost (Paper 4G)**

Introduction

1. In October 2007, the Board issued an Exposure Draft of Proposed Improvements to IFRSs. The ED included the Board's proposals to amend IAS 19 Employee Benefits to deal with five issues.

2. There was significant disagreement with one issue. This is discussed in Paper 4H. Constituents largely agreed with the other proposals. The table in Paper 4D lists the proposals, comments made by respondents, and the staff's initial assessment.

3. However they raised important questions on three issues the staff thinks the Board may wish to discuss as a whole.

4. This paper discusses the comments made by respondents to those issues and sets out the staff recommendation.

Background

5. Ambiguous definitions of negative past service costs and curtailments have resulted in diverse accounting for plan amendments that reduce existing benefits.

Accordingly, the Board proposed to amend IAS 19 to clarify that when a plan amendment reduces benefits, the reduction relating to future service is a curtailment and any reduction relating to past service is negative past service cost.

6. Most constituents agreed with the proposed amendment to clarify the distinction between negative past service costs and curtailments. However some respondents commented that:

- More guidance is needed on the distinction between a negative past service cost and curtailment.

- The proposed amendment ignores the fact that benefits may be improved and still cause the defined benefit obligation to decrease.

- Full retrospective application of the amendment would be difficult.

7. The Board also proposed to delete a reference to materiality in paragraph 111 of IAS 19 as follows:

   A curtailment occurs when an entity either

   (a) is demonstrably committed to make a ~~material~~ <u>significant</u> reduction in the number of employees covered by a plan; or

   (b) amends the terms of a defined benefit plan ~~such~~ <u>so</u> that a ~~material~~ <u>significant</u> element of future service by current employees will no longer qualify for benefits, or will qualify only for reduced benefits.

8. Most constituents agreed with the removal of the reference to materiality in paragraph 111. However some constituents asked for further clarification of the distinction between material and significant.

Staff recommendation

9. The staff recommends that (mark-ups are from the Board's proposals, not from the current wording in IAS 19):

   (a) Paragraph 111 be amended to clarify further the distinction between a curtailment and negative past service cost as follows:

   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<u>, or a reduction in or removal of the link to future salary increases.</u>

(b) Paragraph 97 be amended to clarify that it is the change in the defined benefit obligation that determines whether or not there is a past service cost, rather than a subjective assessment of whether the benefits have been improved or reduced.

Negative past service cost arises when an entity changes ~~reduces~~ the benefits attributable to past service ~~under an existing defined benefit plan~~ such that the present value of the defined benefit obligation decreases.

(c) The Board add specific transition arrangements for the implementation of the amendment in respect of curtailments and negative past service costs in paragraphs 97, 98 and 111 as follows:

159D Paragraphs 7, 32B, 97, 98 and 111 were amended and paragraph 111A was added in [Month] 2008 as part of the first annual improvements project. An entity shall apply the~~se~~ amendments in paragraphs 7 and 32B for annual periods beginning on or after [1 January 2009]. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact and:

(a) apply the amendments to other IFRSs introduced by the first annual improvements project; and

(b) apply IAS 1 Presentation of Financial Statements (as revised in 2007) for that earlier period. [*]

An entity shall apply the amendments in paragraphs 97, 98 and 111 to changes in benefits that occur on or after [1 January 2009].

(d) The Board affirm its proposal to replace the word ‘material’ with the word ‘significant’ in paragraph 111.

Negative past service costs and curtailments

10. Some constituents commented that it is still difficult to distinguish between negative past service costs and curtailments. The Board’s proposals (paragraph 5) distinguish between past and future service. However, many amendments

[*] To be considered in general for all amendments at the March Board meeting.

appear to affect both past and future service and it’s not clear how the distinction would work in practice.

> “it is unclear to us how an amendment that reduces a final salary plan from 2% of final salary for each year of service to 1%, should be treated. While it appears that both past and future service are affected, we believe that the adjustment to the liability is in respect of the service rendered to date, and that this should be treated as a negative past service cost.” [CL 32]

11. When the Board discussed a similar example, it agreed that the effect of any plan amendment should be broken down into elements that relate to past service (eg accrual rate) and elements that are dependent on future service (eg the effect of future salary increases included in the defined benefit obligation or the effect 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).
12. Therefore, in the example above, the amendment changes the accrual rate and would be a negative past service cost.
13. If the amendment reduced the benefit from 2% of final salary to 2% of the final 5 year average of salaries, then the effect on the defined benefit obligation of the change from final salary to final 5 year average salary would be a curtailment. If the amendment, instead, changed the benefit promise from 2% of final salary to 1% of the final 5 year average of salaries, then the effect of the change from final salary to final 5 year average salary would be a curtailment and the effect of the change in the accrual rate from 2% to 1% would be a negative past service cost.
14. The staff notes that such an approach may appear counterintuitive to some, especially those who think that a specific curtailment event, such as a sale of part of a company or large scale redundancy, must have occurred in order for a curtailment to occur.
15. Therefore in order to clarify the Board’s intentions regarding the link to past and future service (particularly with respect to future salaries) the staff recommends that paragraph 111 be amended to clarify further the distinction between a curtailment and negative past service cost as follows:

> 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<u>, or a reduction in or removal of the link to future salary increases.</u>

16. Some respondents also asked for a more precise definition of negative past service costs

> The proposed amendments … fail to recognise that in some situations, an amendment to the plan can improve benefits but still result in a reduction in the obligation. For example, the plan could be amended to allow for a larger lump sum to be claimed on retirement. [CL 14]

17. The staff notes that if the benefit is improved in economic terms, then the present value of the defined benefit obligation would usually increase. However, because the measurement of the liability for the benefit is not fair value, it is possible that this is not always the case. In rare cases, it is possible that the fair value of the benefit may increase, but the IAS 19 measurement of the defined benefit obligation decrease.

18. Also, some may take the view that an amendment is an improvement because of the other benefits it confers. For instance, the additional liquidity afforded by being able to receive a greater portion of a benefit as a lump sum (particularly if this is tax effective) would be regarded as an improvement by many, even if the commutation rates implied that the *economic* benefit received is lower.

19. The staff thinks that the Board should make the wording of the definition in paragraph 97 more precise in order to clarify the Board' s intentions as follows:

> Negative past service cost arises when an entity <u>changes</u> ~~reduces~~ the benefits attributable to past service ~~under an existing defined benefit plan~~ <u>such that the present value of the defined benefit obligation decreases</u>.

Transition provisions

20. The Board required full retrospective application of the amendment to negative past service costs and curtailments. Some constituents disagreed with this because retrospective application requires an entity to split the cumulative actuarial gains and losses from the inception of the plan until the date the amendment is effective into a recognised portion and an unrecognised portion.

21. For those entities that use the option to defer gains and losses, this would be a very cumbersome and difficult task and the benefits are unlikely to outweigh the costs of doing it. Therefore the staff recommends that the Board change the transition requirements for the amendments to IAS 19 by amending paragraph 159D as follows:

(a) 159D Paragraphs 7, 32B, 97, 98 and 111 were amended and paragraph 111A was added in [Month] 2008 as part of the first annual improvements project. An entity shall apply the~~se~~ amendments <u>in paragraphs 7 and 32B</u> for annual periods beginning on or after [1 January 2009]. Earlier application is permitted. …

(b) <u>An entity shall apply the amendments in paragraphs 97, 98 and 111 to changes in benefits that occur on or after [1 January 2009].</u>

Significant vs Material

22. As mentioned above, the Board proposed to delete a reference to materiality in paragraph 111 of IAS 19 (paragraph 7 above).

23. Some respondents asked for further clarification of the Board's intentions in changing material to significant.

24. According to paragraph 30 of the *Framework*:

> Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

25. Significant, on the other hand, is not a defined term in IFRSs but is used throughout IFRSs to denote the degree of importance or relevance, eg *significant costs (IAS 16) significant increase in turnover rates (IAS 19), significant period of time (IFRS 2).*

26. Some respondents questioned whether it is possible to have a material change in the number of employees that is not significant. The staff notes that it is not meaningful to say there is a 'material' change in the number of employees in IAS 19 since the standard does not require that number to be disclosed in the financial statements.

27. Further, paragraph 29 of the *Framework* clarifies that the relevance [significance] of information is affected by its nature and materiality'. The staff thinks this implies that a material change would be significant.

28. Since the word 'significant' is used in its normal sense, the staff does not recommend that the Board provide any further clarification. Instead entities should be encouraged to apply professional judgement.