IASB Meeting | Agenda reference **3A**

Staff Paper | Date **April, 2009**

Project **Post-employment benefits**

Topic **Recognition of changes in defined benefit obligations and in plan assets**

Purpose of this paper

1. In previous meetings, the Board has made tentative decisions about the presentation of changes in the net pension asset/liability (summarised in Appendix A). In the context of these tentative decisions, this paper asks the Board to confirm its preliminary view that entities should present all changes in the defined benefit obligation and in plan assets in the period in which they occur.

Summary of staff recommendations

2. The staff recommends that the Board confirms its preliminary views that:

   (a) entities should recognise all changes in the value of plan assets and in the post-employment benefit obligation in the financial statements in the period in which they occur (Question 1).

   (b) entities should recognise unvested past service cost in the period of a plan amendment (Question 2).

This paper has been prepared by the technical staff of the IASB for the purposes of discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper and do not purport to represent the views of any individual members of the Board or the IASB.

Decisions made by the Board are reported in IASB *Update*.

Official pronouncements of the IASB are published only after the Board has completed its full due process, including appropriate public consultation and formal voting procedures.

Recognition of changes in plan assets and in the post-employment benefit obligation

3. The Discussion Paper set out the preliminary view that:

> Entities should recognise all changes in the value of plan assets and in the post-employment benefit obligation in the financial statements in the period in which they occur. (PV2)

4. A significant majority of comment letters, including all the user responses, supported PV2. For example:

> "Completeness requires the financial statement recognition and measurement of economic events that can affect investors' wealth, including changes in fair value as they occur. Thus, no accounting standard should permit assets or liabilities, and changes in them that can affect shareowners' wealth, to escape recognition at the time they occur in the financial statements."[1]

5. However, some respondents disagreed with PV2. We have grouped their comments as follows:

   (a) Comments on the interaction with the financial statement presentation project and other possible phases of a pension project (see paragraphs 6-10).

   (b) Comments that measurement issues need to be addressed before recognition and presentation (see paragraphs 11-17).

   (c) Comments citing volatility in profit or loss as a reason not to confirm PV2 (see paragraphs 18-22).

   (d) Other comments (see paragraph 23).

Interaction with other projects

6. Some comment letters argue that we should not require immediate recognition of changes in the defined benefit obligation and in plan assets until the financial statement presentation project is completed.

7. Some comment letters also note the possibility of further changes in the recognition and presentation of gains and losses, if the Board proceeds with a second phase of this project. They argue that it would be unfair to make two fundamental changes in quick succession.

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[1] CL96

8. We acknowledge that the Board has yet to answer some general questions about financial statement presentation in its financial statement presentation project. However, the Board has previously decided that it should address presentation of pension costs in this project now, rather than risk delaying progress on immediate recognition by waiting for the financial statement presentation project to address presentation. Of course, we hope that the decisions made on presentation in this project will inform the Board's thinking on financial statement presentation generally, thereby reducing the possibility of two fundamental changes in presentation.

9. In response to the comment about future changes arising from a second pensions project, we note that the scope and timing of any further pensions project is as yet unclear. Any decisions taken in this project could be in place for several years.

10. Accordingly, we do not think that the timing of other Board projects should preclude the Board from confirming its preliminary view that all changes in the defined benefit obligation and in plan assets should be recognised in the period in which they occur.

Measurement issues

11. Some comment letters argue that the Board should not tackle recognition and presentation issues until it addresses the measurement of defined benefit obligations and plan assets. They argue that to do so might hamper the faithful representation of the entity's position and performance. For example:

> "It is not clear that requiring recognition of amounts determined using methods that have been identified as flawed and that are in the scope for a longer term project provides improved financial reporting in the short-term"[2]

12. Some state that the corridor is a fundamental part of the current defined benefit measurement model that was intended to take account of the long-term maturity of the pension obligation. They argue that there have been no developments

[2] CL95

since the IASC issued IAS 19 that would justify removing that part of the model.

13. Some actuarial firms argued that immediate recognition is ultimately the right approach, but contended that special presentation is required for pensions to avoid giving a misleading impression that pension liabilities are more volatile than other liabilities that are not measured at current value (for example, many non-derivative financial liabilities are measured at amortised cost).

14. In the staff's view, the deferral features of pension accounting are layered on top of the basic accounting model; they are not necessary components of the model. The Board accepted that view in embarking on this project. We continue to think that the Board could address recognition and presentation issues without also reconsidering measurement. Some of the comment letters support this view, for example

> "The deferred recognition (the corridor approach) represents a smoothing mechanism and is without principle. Further, this option is one of the significant sources of complexity within IAS 19. Additionally, its elimination does not interact with other aspects of IAS 19 and therefore it is unlikely that the decision to eliminate the ability to defer recognition of changes in defined benefit assets and obligation would need to be revisited when the Board undertakes a comprehensive review of IAS 19."[3]

15. We note that the reasons for the Board examining recognition and presentation at this time are:

    (a) The FASB recently issued SFAS 158. SFAS 158 requires entities to recognise the net pension asset/liability on the balance sheet.

    (b) When the Board started this project, it expected developments in its project on financial statement presentation would facilitate progress on pensions. In particular, the Board expected that project to address (i) what should be recognised in other comprehensive income and (ii) recycling. It now appears that the financial statement presentation project will not address those issues. Therefore, the Board decided to address them as part of this project.

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[3] CL105

(c) In last year's update to the Memorandum of Understanding with the FASB, the Board set a target of delivering by 2011 revisions to IFRSs that would substantially improve the financial reporting for post-employment benefits. Eliminating smoothing and deferral mechanisms would be a substantial improvement, sufficient to justify revisions to IFRSs at this stage.

16. We note that the credit crisis has put greater pressure on some measurement issues, in particular those relating to the discount rate. Nonetheless we think that delayed recognition of gains and losses makes it more difficult for users of financial statements to understand the limitations of the measurement method.

17. Accordingly, we think that measurement issues should not preclude the Board from confirming its preliminary view that all changes in the defined benefit obligation and in plan assets should be recognised in the period in which they occur

Volatility

18. Some respondents opposing immediate recognition argue that pensions are long term liabilities and so the volatility from year to year should be treated differently from the volatility of short term items. In particular, they argue that:

(a) reporting changes in the fair value of plan assets or the defined benefit obligation to each period results in volatility in profit or loss that is not relevant to decisions based on the longer-term prospects of the entity because of the possibility of offset of past gains or losses by future losses or gains.

(b) the volatility in profit or loss that results from reporting all changes in the net pension asset/liability in profit or loss does not generate useful information for users. That volatility impedes year-on-year comparability and obscures the profitability of the core business.

(c) regardless of whether the volatility resulting from immediate recognition of changes in the fair value of plan assets or the defined benefit obligation is a faithful representation of economic events, it is too great to be acceptable in financial statements. Estimates in the comment letters included:

(i) "German companies would have reported swings in P&L of up to 40%."[4]

(ii) "the quarterly income after taxes as reported in the period from the beginning of 2007 to the first quarter of 2008 (a period of increasing market rates) would have been doubled or even tripled in particular quarters. If discount rates had fallen (as for example during fiscal 2005), income after taxes would have decreased significantly. In one quarter, a profit after taxes would have been reversed into a loss of twice the amount."[5]

(iii) "Deutsche Post World Net's (DPWN's) 2004 and 2005 reported EBIT figures would have reduced by approx. 20% and 30%, respectively. On the other side, 2006 and 2007 EBIT figures would have increased by approx. 10% and 40% (about 1.400m EUR), respectively."[6]

(iv) JPMorgan provided an analysis for British Telecom's 2006/2007 results (research report from Sarah Deans (JPMorgan), dated 4 April 2008). According to this analysis, the reported net income would have increased by 52 % by applying the "all through profit or loss approach" (approach 1 proposed by the Board). Major German DAX companies would have reported significant fluctuations for their 2007 earnings, too.[7]

19. Some comment letters also argued that undesirable behavioural effects might result from reporting volatility arising from pensions in profit or loss:

(a) Entities may try to eliminate short term volatility by making long term economically inefficient decisions. For example, the volatility caused by immediate recognition may affect decisions regarding the allocation of plan assets, or cause undue management focus on the actuarial judgements taken in arriving at the pension fund assumptions. This may have a detrimental effect on the cost of the benefit over the long term.[8]

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[4] CL32
[5] CL33
[6] CL56
[7] Quoted by CL56
[8] eg CL7, CL32, CL61

(b) The additional volatility may prompt employers to amend plan terms in order to reduce volatility. This would have undesirable social consequences.[9]

(c) Immediate recognition could cause potential difficulties to covenants based on earnings or net assets, and may affect entities' ability to pay dividends, owing to legal restrictions based on balance sheet, retained earnings or income statement values.[10]

20. The Board considered these and similar arguments in its deliberations leading to the discussion paper. The Board's counter-arguments are:

(a) It is not inevitable that future gains and losses will occur and offset past losses and gains. If the original actuarial assumptions are valid, future fluctuations may offset each other and not offset past fluctuations.

(b) Immediate recognition provides the most useful information to users because it generates amounts in the statements of financial position and comprehensive income that are transparent, easy to understand and provide information about changes in the post-employment benefit obligation and plan assets in that period. It improves comparability across entities by eliminating the options currently allowed by IAS 19.

(c) A measure should be volatile if it represents faithfully transactions and other events that are themselves volatile. Similarly, if post-employment promises and the gains and losses arising from them are, in reality, large compared with those of business operations, the financial statements should reflect that fact.

(d) The information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of financial information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

(e) The effects on loan covenants and dividend distributions are a matter for the banks and regulatory authorities concerned. Clear and consistent disclosure will allow lenders and borrowers to adjust these items in whatever way they feel is appropriate for their particular needs.

21. Accordingly, we do not think that concerns about volatility should preclude the Board from confirming its preliminary view that entities should recognise all

[9] eg CL87
[10] eg CL1

changes in the defined benefit obligation and in plan assets in the period in which they occur.

22. We also think that the Board's tentative decision that the remeasurement component[11] of pension cost should be presented separately in the income statement net of tax effects might alleviate some concerns about volatility because it allows entities to draw a subtotal of profit before tax and pension remeasurement.

Usefulness of information

23. In addition to the specific concerns about volatility, the comment letters raised the following general points about the usefulness of the information that would result if the Board required immediate recognition:

    (a) The cost required to implement immediate recognition does not outweigh the perceived improvement in the resulting measures of the liability.

    (b) Users eliminate information about changes in pension cost in performing financial statement analysis because it has less predictive value than information about an entity's operations.

24. We disagree:

    (a) We do not think that the cost to implement immediate recognition should be high because entities are already required to provide this information in the notes.

    (b) Information about pensions cost has a different predictive value from information about an entity's operations. However, that does not make it irrelevant. The objective of financial statements is to convey information about the uncertainty and timing of cash flows, as well as their amount. The changes in pension cost will affect the timing and amount of future cash flows from the entity.

Summary

25. In summary:

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[11] Defined as changes in the defined benefit obligation (other than interest cost), the actual return on plan assets, the gain or loss on settlement and the effect of the asset ceiling.

(a) Immediate recognition provides the most useful information to users because it generates amounts in the statements of financial position and comprehensive income that are transparent, easy to understand and provide information about changes in the post-employment benefit obligation and plan assets in that period. It improves comparability across entities by eliminating the options currently allowed by IAS 19.

(b) The Board should address presentation of pension costs under IAS 1 in this project now, rather than risk delaying progress on immediate recognition by waiting for the financial statement presentation project to address presentation.

(c) Delayed recognition of gains and losses makes it more difficult for users of financial statements to understand the limitations of the existing measurement model in IAS 19.

(d) Information contained in financial statements will not be neutral if it is produced in a way that is intended to achieve a predetermined result or outcome, such as reduction in volatility and more predictable earnings.

(e) We do not think that the cost to implement immediate recognition should be high because entities are already required to provide this information in the notes.

Recommendation and Question 1

For the reasons summarised in paragraph 26, the staff recommends that the Board confirm its preliminary view that entities should recognise all changes in the value of plan assets and in the post-employment benefit obligation in the financial statements in the period in which they occur.

Does the Board agree?

26. Some comment letters asked that the Board provide fuller justification for immediate recognition in the Basis for Conclusions. We have noted this and intend to attempt to do so in drafting.

Recognition of unvested past service cost

27. Most respondents agree with the Board's preliminary view that unvested past service cost should be recognised in the period of a plan amendment (PV4). For example:

> "We agree with the Board that all past service costs should be recognized immediately in the income statement in the period in which a plan is amended. This is consistent with the principles in

> IAS 19. We recognise that there is an inconsistency between the treatment required by IAS 19 and that required by IFRS 2. However, this is one of a number of differences between IAS 19 and IFRS 2 and it is preferable[…] to retain the principles in IAS 19 and ensure that the standard is internally consistent."[12]

28. Some constituents, while acknowledging that reconsideration of past service cost may be necessary, argue that the Board should defer this issue to a comprehensive project.

> ...while we believe that the treatment of unvested [past service costs needs to be reconsidered, we do not believe that this is an issue that requires immediate attention. Plans that include unvested past service costs are not widespread, they affect only a limited number of jurisdictions and they do not present significant practical issues. Further no compelling arguments have been presented to demonstrate that the current treatment of unvested past service costs represents a significant conceptual flaw. Therefore, while we recognise that the amortisation of unvested past service costs could be considered inconsistent with the immediate recognition of other elements of defined benefit plans, we suggest that the appropriate treatment for unvested past service costs be reconsidered as part of the Board's planned fundamental review of the accounting for employee benefits."[13]

> "We believe that this change would introduce confusion for readers of accounts who are familiar with the current rules, without a compelling benefit. We therefore suggest that this change is deferred to the second phase of the project."[14]

29. Others disagreed with the Board's conclusion that entities should recognise all effects of changes arising from plan amendments, including unvested past service costs, in profit or loss in the period in which the plan amendment took effect. They gave the following reasons:

    (a) The Board should not amend IAS 19 in a way that is inconsistent with what some regard as the best conceptual answer, set out in IFRS 2. Some argue that recognition of past service cost over a vesting period would better reflect the economics of an entity improving benefits in the expectation of future service.

    (b) The proposals are not consistent with SFAS 158 which requires recognition of past service cost in other comprehensive income. Some

[12] CL88
[13] CL105
[14] CL89

proposed that entities should recognise past service costs in other comprehensive income with recycling of subsequent years over a period corresponding to the life of the future economic benefit.

(c) The proposal might discourage companies from improving benefits offering higher benefits in return for future service.

30. One comment letter disagreed with an argument in paragraph 2.20 of the Discussion Paper

> "attributing benefit accrual in line with the plan benefit formula requires for consistency that unvested past service costs should be recognised immediately rather than over the period until they become vested. In fact we believe the converse is the case. Attributing (unvested) benefit accrual in line with the plan benefit formula involves the recognition, over the period until they become vested, of benefits that are accrued (under the plan benefit formula) over that period. This is completely consistent with recognising unvested past service costs over the period until they become vested.[15]

We disagree. When a benefit formula attributes unvested benefits to a past period, IAS 19 regards that unvested benefit as a liability, and we believe that entities should recognise that liability.

31. The Board was aware of the inconsistency with IFRS 2 in arriving at its preliminary view in the discussion paper. This was discussed in paragraphs 2.16-2.21 of the discussion paper (reproduced in Appendix B). In response to the other objections raised in the comment letters:

(a) The proposal to recognise the unvested past service cost in other comprehensive income to be recycled over the vesting period would have the same effect on profit or loss as deferred recognition. The FASB took this approach for all actuarial gains and losses. However, the Board has chosen a different approach for actuarial gains and losses and the proposals in the discussion paper are consistent with that approach.

(b) It is not the role of accounting standards to either encourage or discourage provision of benefits.

[15] CL87

Recommendation and Question 2
The staff recommends the Board confirm its preliminary view that entities should recognise unvested past service cost in the period of a plan amendment. Does the Board agree?

Appendix A: Summary of tentative decisions to date

In previous meetings, the Board tentatively decided:

(c) An entity shall disaggregate changes in the net defined benefit asset or liability into three components:

   (i) service cost, including the gain or loss on curtailment.

   (ii) interest cost on the defined benefit obligation.

   (iii) remeasurements, comprising:

   - other changes in the defined benefit obligation and in plan assets, including the actual return on plan assets
   - the gain or loss on settlement
   - the effect of the asset ceiling.

(d) An entity shall present the remeasurements component separately in the income statement net of tax effects.

(e) An entity shall present the interest cost on the defined benefit obligation in the same way as other finance costs.

(f) An entity shall disclose the service cost and interest cost on the defined benefit obligation either in the income statement or in the notes.

Appendix B

Plan amendments (reproduced from discussion paper)

2.16 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 requires entities to recognise past service costs from vested benefits immediately, and recognise past service costs from unvested benefits on a straight-line basis over the average period until the benefits vest.

2.17 Because IAS 19 characterises past service cost as increasing the present obligation that arises from employees' past service, the Board's preliminary view is that entities should recognise unvested past service cost in the period of the plan amendment. This approach is also consistent with the approach in SFAS 158, which requires entities to recognise in other comprehensive income unvested prior service cost in the period of the plan amendment.

2.18 The Board noted that some contend that entities amend or introduce plans to remunerate employees for future services, not for service already delivered, even if the terms of those plan amendments attribute benefits to past service periods. For example, the attribution of benefits to past service may be a means of assigning a fixed amount of increased remuneration among existing employees. Those holding this view assert that immediate recognition could misstate employee remuneration because entities would report a higher expense in the year of the plan amendment than in the following years when, in fact, remuneration is stable.

2.19 The Board acknowledged that attributing changes in unvested benefits arising from plan amendments to future service from employees would be consistent with other IFRSs. For example, IFRS 2 *Share-based Payment* and the proposed treatment of unvested termination benefits in the exposure draft of amendments to IAS 19 (published in June 2005) regard increases in benefits with a vesting period as attributable to employees' future services until vesting date.

2.20 This project does not include re-examining the accounting for defined benefit plans based on a benefit formula. If the Board retains the attribution of benefit in accordance with a benefit formula, then unvested past service cost is a liability in

accordance with IAS 19. The alternative view, that unvested past service cost should be recognised over the vesting period, would be consistent with what the Board thought were the best conceptual answers in IFRS 2 and the proposed amendments to IAS 19. However that approach would result in deferred recognition of an amount that is regarded as a liability in IAS 19. In other words, immediate recognition of unvested past service cost based on the benefit formula would allow both:

(a) a retention of the general requirement in the existing IAS 19 to attribute benefits to periods of service using the benefit formula, and

(b) consistency with immediate recognition of all gains and losses arising from defined benefit plans but it would result in an approach that is not consistent with what the Board thinks is the best conceptual answer.

2.21 The Board noted that the accounting for defined benefit liabilities in IAS 19 is different from the accounting for liabilities in other IFRSs. However, the Board recognised that the inconsistency between the accounting model in IAS 19 and IFRS 2 is not an issue to be addressed in this project. The Board's preliminary view is that it should retain the general requirement to attribute benefits to periods of service using the benefit formula and therefore that entities should recognise all effects of changes arising from plan amendments in the period in which the plan amendment took effect.