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International
Accounting Standards
Board

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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:	**February 2009, London**
Project:	**IFRS for Non-publicly Accountable Entities (formerly Private Entities, formerly SMEs)**
Subject:	**Simplifying the approach for measuring an NPAE's cost and obligation under a defined benefit plan (Agenda Paper 8)**

Objective of Discussion at this Board Meeting

1. The objective of the discussion at the February 2009 Board meeting is to continue redeliberating the proposals for measuring an NPAE's cost and obligations under a defined benefit plan in Section 27 *Employee Benefits* of the Exposure Draft (ED) of a proposed IFRS for SMEs. Redeliberation of this matter was originally presented to the Board in Agenda Paper 8B for the July 2008 Board meeting as Issues 27.3 and 27.4. Redeliberation continued at the November 2008 Board meeting (see Agenda Paper 14B).

Agenda Papers for January 2009

2. For the February 2009 Board meeting, this is the only NPAE agenda paper. It has two attachments, as follows:
    a. **Attachment 1.** E-mail sent by NPAE project staff to Employee Benefits Working Group members in December 2008.
    b. **Attachment 2.** Excerpt about "Alternative Measurement Method for Employers with Fewer Than One Hundred Plan Members" from Statement 45 of the US Governmental Accounting Standards Board.

Redeliberation of Section 27 to Date – Issues Other than the Principle for Measuring a Defined Benefit Obligation

3. The issue before the Board in February 2009 is the basic principle for measuring an entity's cost and obligation under a defined benefit plan. The Board has already reached tentative decisions in its redeliberation of other aspects of Section 27, as follows:

    a. The Standard should allow a choice of two methods for recognising all actuarial gains and losses– immediate recognition in profit or loss (as proposed in the ED) and immediate recognition in other comprehensive income. Deferral of actuarial gains and losses will not be permitted.

    b. All past service cost should be recognised immediately in profit or loss as proposed in the ED.

    c. Subsidiaries should be permitted to recognise a charge based on a reasonable allocation of the group charge if the parent presents consolidated financial statements under the IFRS for NPAEs or full IFRSs.

    d. The final Standard should retain the requirements for multi-employer plans as proposed in the ED (and contained in IAS 19), ie when sufficient information is not available to use defined benefit accounting for a multi-employer plan that is a defined benefit plan, an entity should treat the plan as a defined contribution plan with appropriate disclosure.

    e. Entities should not be required to divide the return on assets into an expected return and an actuarial gain or loss.

Redeliberation of Section 27 to Date – Principle for Measuring a Defined Benefit Obligation

4. In July 2008, the Board discussed whether, and in what circumstances, NPAEs might be allowed to measure the defined benefit obligation at a current termination amount, if information to apply the projected unit method as proposed in the ED was not available. No decisions were made. The Board asked the staff to present a proposal at a future meeting that specifically sets out when a current termination amount might be used and exactly how it would be calculated, because current practice varies.

5. In November 2008, staff recommended amending the ED to state that if sufficient information is not available without undue cost or effort to determine the present value of the defined benefit obligation and related current service cost under a defined benefit plan using the projected unit credit method, or determining the obligation that way would be of questionable reliability and usefulness because of the small number of employees involved, an entity should measure the defined benefit obligation of that plan at the current termination amount, defined as the vested benefit obligation at the balance sheet date assuming all employees were to terminate their employment as of that date using current salary information, and give supplementary disclosures.

    a. The Board did not agree with the staff recommendation, primarily because unvested benefits would not be taken into account.

    b. At the same time, the Board continued to express a view that the defined benefit accounting under IAS 19 *Employee Benefits* should be simplified for NPAEs. The Board asked the staff to bring back an approach at a future meeting that is more in line with the current IAS 19 approach (eg it includes consideration of unvested benefits), but would be something that entities would generally be capable of applying themselves without needing to use external specialists. The Board suggested that the staff should also consider whether the concept of accumulated benefit obligation in SFAS 87 might be suitable. The Board suggested that staff seek the views of pension experts on whether a simplified measurement scheme can be developed that takes unvested benefits into account and that does not require a small entity to engage an actuary on an ongoing basis. As explained further below, the staff sought the views of pension experts first by inviting written comments from members of the Board's Employee Benefits Working Group (e-mail to the WG in December 2008 – Attachment 1 to this Agenda Paper) and then by discussion of the issue at the meeting of that WG on 26 January 2009.

    c. The Board agreed with the staff recommendation that additional clarification should be added to the ED to state that under defined benefit accounting, an actuarial valuation performed by an outside actuary is not required to be done every year and that guidance should be added on when a roll forward is appropriate and how it should be performed.

    d. The agenda paper for the November 2008 meeting noted that if the Board agreed with the staff recommendation for measurement at current termination amount, there is no need to provide further simplification by allowing actuarial methods other than the projected unit method to be used for defined benefit accounting. Because the Board did not agree with the staff recommendation, this possibility was among the ones commented on by the WG members.

Advice from the Employee Benefits Working Group

6. In December 2008, the NPAE project staff wrote to WG members asking for views on possible simplifications. Our request to the WG set out criteria for an acceptable recognition and measurement approach as follows:

   > We are therefore writing to you, as experts in this area, for suggestions on a simplified approach that meets the following criteria:
   >
   > 1. Recognises pension cost during the employees' periods of service
   > 2. Recognises an obligation for both vested and unvested benefits
   > 3. Simplifies the calculation from that in IAS 19
   > 4. Ideally for small entities (say entities with under 50 employees) does not require an outside specialist to do the calculation

   Starting in paragraph 8 of this agenda paper, the responses received from WG members are summarised.

7. Fortuitously, the WG was scheduled to meet on 26 January 2009, and approximately one hour of agenda time was set aside for discussion of the NPAE issue. The agenda paper and attachments for that meeting included:

   a. the full text of Section 27 of the ED;

   b. a summary of all Board redeliberation decisions to date on Section 27;

   c. an excerpt from the Agenda Paper presented to the Board in November 2008, which included all significant comments on Section 27 received in comment letters and field test submissions as well as the views of the Private Entity Working Group;

   d. the staff proposal for a simplified approach for NPAE defined benefit plans that the Board considered in November 2008 but did not support;

   e. Statement 45 of the US Governmental Accounting Standards Board, which includes simplified measurement for entities with fewer than 100 employees and which one of the WG members suggested for review;

   f. Summary of Board decisions on Section 27 to date.

Responses from WG Members to the December 2008 letter

8. The responses received are summarised in paragraphs 10 to 16 below. Some WG members commented on aspects of Section 27 that are not directly related to the measurement of defined benefit plans. Whilst those comments are not listed below, they are being considered separately by the project staff.

9. Key:

   - PBO – Projected benefit obligation = Present value of expected payments using future salaries
   - ABO – Accumulated benefit obligation = Present value of expected payments using current salaries

- VBO – Vested benefit obligation = Present value of vested portion of expected payments using current salaries.

10. **WG Member 1**:

    - Regarding countries that have laws that mandate long-service benefits for all or most employees that are similar to defined benefit plans, the key words are ‘long service benefits’. If they provide benefits for almost all lengths of service, the current termination amount would be appropriate. Alternatively, if they provide very long service benefits only, it would be inappropriate. In the latter cases, this WG Member supports the Board's view.

    - In such cases, at least two elements are necessary to consider, (1) attribution on a straight-line basis [ie at each reporting date the vested + unvested obligation would be calculated based on service and salary to date, and that amount would be spread over the estimated remaining employee service period, without discounting, with a "true up" at each reporting date], (2) turnover rate or survival rate (very simplified basis calculation should be permitted). In order to avoid ignoring unvested obligation, (1) is necessary. When they take (1), without (2) the obligation amount will be higher than the reality. NPAEs may not be able to do this calculation and get reliable results.

11. **WG Member 2**: There currently exists a differential reporting standard for those entities that are not publicly accountable in this country but no exemption for defined benefit accounting. As part of the IFRS transition, the standard setting board is re-examining employee future benefits and at this time the proposal is to try and achieve simplification and require:

    - use of funding valuation as a basis for measurement, and

    - elimination of smoothing.

    Under this approach, all actuarial gains and losses and past service costs would be recognised in income when they occur. Other plans would continue to follow the IAS 19 equivalent standard. [Staff comment: Staff presume ‘other plans’ means those that are not funded on some actuarial basis].

12. **WG Member 3**:

    - Strongly rejects defined contribution accounting or disclosure only for defined benefit plans [as does the IASB]. Supports the staff recommendation (ie, termination amount / VBO). However, notes that the staff recommendation to use a termination amount defined in terms of what would be paid if the employees terminate would mean mortality risk would remain with the employer and this in itself would trigger the involvement of an actuary.

    - Where these arrangements are required by government and legislation specifies a lump sum amount that would be payable if the employer terminates employment, using this lump sum might be satisfactory. In some cases this amount may be excessively prudent, but could at least be a number that the entity could get hold of without an outside specialist.

13. **WG Member 4:** Does not support a simplified approach. Notes simplifying the calculation of a defined benefit obligation for non-pension post-employment benefits for smaller entities was given great consideration in the development of

Statement 45 of the US Governmental Accounting Standards Board (see paragraphs 33-35 of that Statement). Suggestion:

- The ABO (or perhaps even the VBO) is a superior measure of the obligation than the PBO and the respondent would support its use for all plans. It will not have an appreciable impact on the cost of calculating the value of those benefits, unless the benefits are normally described as a lump sum accrued to date which will always be paid. To the extent the VBO is used, an additional disclosure as to the likely increase in the VBO in each of the next 5 years would be important for users when few vested benefits now exist, but many will exist in the future.

- Should allow expense to equal the value of the benefits earned this year, plus interest accrued on previously earned benefits, minus investment returns (either expected or actual) credited to the employer. Many of the mandated long-service plans that are similar to defined benefit plans are often not funded, so the last element above would be zero. In addition, the definition of expense could be expanded to include the value of any past service benefits provided during the year.

- Additional increases in the ABO beyond those described in the bullet point above could be recorded as other comprehensive income/in statement of recognised income and expense.

- One possibility for cost savings is not requiring annual calculations. Requiring an updated valuation every three years would more than halve the cost, on average (the cost is not cut in thirds because there would be a cost each year to roll-forward the prior year's results.) Of course the tradeoff is ‘old’ figures in the financial statements.

14. **WG Member 5:** A simplified approach is difficult to find since the Board will not accept defined contribution accounting and wants to capture vested and unvested benefits. Although the ABO still needs expert input, it is simpler than the PBO basis, as the PBO basis needs to factor in the increase in salary rates. Suggestion:

    - Schemes always have some form of valuation by an expert at some time - typically a three year triennial (I’m unaware of an exemption from this). At this time it should be possible to have the accounting numbers calculated.

    - It is relatively straightforward to role these numbers forward if the discount rate is not changed - and a little easier still using the ABO valuation. With an unchanged discount rate, the liability at year 1 would be liability year zero plus one year’s unwind plus annual payments in (regular accrual cost) less any transfers out (transfers out would be a little different to the accounting liability - but they are infrequent). Basically with the fixing of the discount rate for a period of three years, the next two years liabilities can be calculated in house without further expert input.

15. **WG Member 6:**

    - An actuarial method such as the ABO would be acceptable but create a different philosophy from that followed by IAS 19. The ABO is not that much easier to determine than the PBO. To really simplify the calculation procedure, the VBO would be a good proxy measure for the ABO when discount rates are close, turnover is not too high, and there is vesting. An alternative to the VBO could be the present value of accrued (not necessarily vested) benefit (=ABO without assuming any turnover), being at least equal to the VBO. This information should not be too difficult to obtain and calculations would be more straightforward, even for non actuaries.

- It's of upmost importance to have clear-cut wording (leaving as little space as possible for interpretation) if, again, the intention is to have a standard that can be handled by 'in-house' non specialists. Implementation guidance would be welcome.
- The suppression of deferral mechanisms (eg the corridor) which still exist under IAS 19 is likely to be somewhat penalising.

16. **WG Member 7:** Does not think it is feasible to simplify the calculations in IAS 19 with the intent to enable the calculations to be performed in-house. Suggestion after discussion with some actuaries who work with NPAEs:

- Actuarial judgment and experience cannot be put into a spreadsheet. Just as one would not rely on a non-accountant to develop financial statements, a qualified professional should be involved in the valuation of benefit obligations.
- Defined benefit plans are discretionary. Most defined benefit plans have inherently complex calculations because the benefit formula has been customised for the company. Final-pay-related plans and retiree medical plans (where the annual benefit is not capped at an amount less than the expected claims) create additional complexity, particularly in projecting cash flows, which is key in measuring the benefit obligation and change from year to year. Complex transactions by necessity require complex calculations. Section 27 would not apply to immaterial plans.
- For "common" plans, such as government plans, we believe software products could be developed that would enable the company to perform an "ABO-type valuation" (ie, without assumed pay growth). This may also be feasible for simple plan designs, eg fixed amount per year of service.
- In the US, and probably most other countries, funding valuations are required to be performed by actuaries. So it would seem the cost of an accounting valuation [if the plan is funded] would be incremental as opposed to an entirely independent exercise.

Summary of Views Expressed at the 26 January 2009 WG Meeting

17. At the WG meeting, staff asked WG members to discuss the following three questions:

Q1 What are WG members' views on the various suggestions in the responses given above?

Q2 Do WG members have any other suggestions?

Q3 Does the WG have a 'consensus view' on whether and how defined benefit pension plan liability and cost measurement could be simplified for NPAEs?

18. WG members agreed that a large number of small entities around the world (several said millions of such entities) had obligations that were, in substance, defined benefit obligations. Often these are imposed by law.

19. WG members acknowledged that actuarial valuations are costly and burdensome for some small entities. Moreover, in some economies there is not a sufficient number of actuaries to value defined benefit plans even though entities had such plans.

20. While some members saw room for simplification by increasing the periods between valuations or by using a unified model that was suitable, yet not perfect, for a wide range of plans, others were concerned to provide such simplification, as pension promises are both complex and risky by nature and that opting for simplistic valuation solutions would obscure that fact. Other proxy measurements mentioned comprised either using a valuation for funding purposes (where funding requirements existed) or quotes for insuring the obligation. However, it was acknowledged that insurance companies would not provide this information without being paid on a recurring basis.

21. One representative of the actuarial profession noted that there were already efforts to provide actuarial valuations on a not-for-profit basis via an association called "Actuaries without Frontiers". Another participant highlighted that involvement of an actuary is not a requirement in IAS 19 and probably this was also true for the IFRS for NPAEs. Some believed that actuaries are sometimes not in a position to provide appropriate valuations because the population of employees would be too small to apply the usual methodologies. It was noted that while for large pension plans, potential measurement errors could be kept within reasonable limits as the "rule of large numbers" applied, the range of possible outcomes and hence the potential for errors would be far greater for plans with only a small number of participants.

22. Views of WG members were divided on whether it is possible to get an actuarially reliable measure of the defined benefit pension obligation for plans with only a few employees. Some felt an expected value measure of the liability could be computed for pensions as it is for obligations under IAS 37. Others questioned the relevance of this measure because of the large amount of inherent variability. This is an issue under IAS 19 and not just under the IFRS for NPAEs.

23. The WG did not agree a 'consensus view' on whether and how defined benefit pension plan liability and cost measurement could be simplified for NPAEs.

24. Most participants agreed that any simplification in accounting must be accompanied by appropriate disclosures.

Comment on GASB 45 Approach

25. One WG member suggested that IASB consider the GASB 45 approach. Attachment 2 to this Agenda Paper includes the relevant excerpt. The GASB approach was designed for employee benefits other than pensions. It is designed for employees of small governmental units in the United States. It includes use of certain tables for assumed employee turnover and benefit projections based on the experience of small governmental units in the United States. Staff have concluded that this approach should not be considered for small business entities globally, since the tables would need to be adjusted for the specific

characteristics of different jurisdictions and updated on an ongoing basis by experts in the different jurisdictions. Accordingly staff are not pursuing it further.

Possible Simplifications for NPAEs Based on WG Members' Written Comments and Discussion

26. Staff have identified the following possible simplifications based on the written comments and discussion of WG members. These simplifications are not all mutually exclusive, that is, in some cases they could be used in combination.

    a. If the plan is funded on an actuarial basis and the actuarial basis takes into account both vested and unvested benefits, measure pension cost based on funding, with disclosure. This method does not report an unfunded pension obligation as a liability.

    b. Measure pension cost and obligation based on the accrued (accumulated) benefit obligation (ABO) rather than the projected benefit obligation (PBO). This still requires an actuarial valuation (it is unlikely that a smaller entity can calculate the ABO without an external specialist) but it is simpler to determine than the PBO in that it does not require projections of future salaries.

    c. Measure pension cost and obligation based on the vested benefit obligation (VBO) with disclosures about unvested benefits.

    d. Measure obligation at the current termination amount, defined differently than in the staff proposal of November 2008. Current termination amount would be the vested and unvested benefit obligation at the balance sheet date assuming all employees were to terminate their employment as of that date using current salary information, and give supplementary disclosures. This does not require projection of future salaries or employee turnover.

    e. Measure the obligation at the quoted price that an insurance company would charge to take on the obligation. Insurance companies will charge for this quotation – in effect the insurance company is being asked to perform actuarial services. In addition, this amount may be difficult to update each year without another quotation.

    f. If a defined benefit plan is government-mandated (for example, statutory long-service pay), and the arrangement specifies a lump sum amount that would be payable if the employer terminates employment, measure the obligation at this lump sum amount.

    g. Measure the obligation at the present value of the accumulated benefit (vested and unvested) without assuming any turnover of employees.

    h. Make clear that an actuarial valuation is not normally required more frequently than once every three years, unless under extreme market conditions or substantial changes in employee demographics. In the interim periods, the valuation would be rolled forward for aggregate adjustments for employee composition and salaries, but without changing the discount rate, turnover, or mortality assumptions.

Staff Recommendation

27. Staff recommend that the requirements for measuring an NPAE's cost and obligation under a defined benefit plan should be based on the following principles.

   a. Pension cost shall be recognised during the employees' periods of service.

   b. A pension obligation shall be recognised for both vested and unvested benefits.

   c. If information based on IAS 19 (projected unit credit, etc.) is already available or can be obtained without undue cost or effort, that method shall be used. This was what the ED proposed for all SMEs.

   d. If information based on IAS 19 is not available and cannot be obtained without undue cost or effort, an NPAE is permitted to use the following principles:

      i. If a defined benefit plan is government-mandated (for example, statutory long-service pay), and the arrangement specifies a lump sum amount that would be payable if the employer terminates employment, measure the obligation at this lump sum amount.

      ii. If the plan is funded on an actuarial basis and the actuarial basis takes into account both vested and unvested benefits, measure pension cost based on funding, with disclosure.

      iii. For other plans not covered in (i) or (ii), measure the obligation at the current termination amount, defined as the vested and unvested benefit obligation at the balance sheet date assuming all employees were to terminate their employment as of that date using current salary information, and give supplementary disclosures.

   e. Make clear that an actuarial valuation is not required more frequently than once every three years, unless under extreme market conditions or substantial changes in employee demographics. In the interim periods, the valuation would be rolled forward for aggregate adjustments for employee composition and salaries, but without changing the discount rate, turnover, or mortality assumptions.

<u>Question 27.3A Overall Measurement Principle</u>

Does the Board agree with the staff recommendation that the requirements for measuring an NPAE's cost and obligation under a defined benefit plan should be based on the principles set out in paragraph 27(a) to (e)?

<u>Question 27.3B "Fallback"</u>

If the Board does not agree with the staff recommendation, which, if any, of the simplification alternatives (a) through (h) in paragraph 26 should staff pursue?