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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Meeting date:	**26 January 2009, London**
Meeting:	**Employee Benefits Working Group**
Paper:	**Simplifying the approach for measuring a private entity's cost and obligation under a defined benefit plan (Agenda paper 5)**

Introduction

1. The IASB is developing an IFRS for Private Entities (formerly small and medium-sized entities, or SMEs). The Board is currently redeliberating the exposure draft (ED) of a proposed IFRS for SMEs that was issued in February 2007. Section 27 of the ED addressed employee benefits. The Board has asked the private entity project staff to consider ways to simplify the approach for measuring a private entity's cost and obligation under a defined benefit pension plan and to present a proposal at a future Board meeting. The staff is seeking advice from the Employee Benefits Working Group (WG). Some time has been allotted at the January 2009 meeting of the WG to discuss this matter.

2. In December 2008, the private entity project staff wrote to WG members asking for views on possible simplifications. This agenda paper highlights the responses received and provides some further background information to facilitate discussion at the WG meeting.

3. This Agenda Paper 5 has the following attachments

- Attachment 1 – Letter emailed to WG members in December 2008 requesting ideas and views about possible simplifications.
- Attachment 2 – The full text of ED Section 27 *Employee Benefits.*
- Attachment 3 – Issues relating to Section 27 that staff presented to the Board in November 2008 (this includes all the Section 27 redeliberation issues except Issue 27.2 on the treatment of past service cost, as the Board had reached a decision on this issue at the July 2008 Board meeting). Attachment 3 contains 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. Attachment 3 includes the staff proposal for a simplified approach for private entity defined benefit plans (see Issue 27.3).
- Attachment 4 – Statement 45 of the US Governmental Accounting Standards Board (reference is made to paragraph 33-35 of Statement 45 by one of the WG members. See comments by Respondent 4 in paragraph 17 of this agenda paper).

Background

4. The objective of the Board's private entity project is to develop a simplified, self-contained set of standards that are appropriate for smaller, non-listed companies. In developing such standards, the IASB's twin goals are to meet user needs while balancing costs and benefits from a preparer perspective.
5. Private entities are entities that are (a) not publicly traded and (b) not financial institutions such as banks. In every jurisdiction in the world, 99% of private entities have fewer than 50 employees. Of course, some of the other 1% could have hundreds and even thousands of employees. Each jurisdiction, and not the IASB, will decide which private entities are permitted or required to use the IFRS for Private Entities. By law in most jurisdictions, all or many private entities, including very small ones, must publish some type of GAAP financial statements.
6. In many jurisdictions, national laws mandate types of employee benefits – such as long-service payments or severance payments – that are similar to defined pension benefits. Hundreds of thousands (possibly millions) of private entities have obligations under these laws.

7. Users of private entity financial statements tend to be more interested in information about short-term cash flows, liquidity, and solvency than in information about longer term earnings and earning power.
8. Between April 2008 and January 2009 the Board has been redeliberating the proposals in all areas of the ED. Employee benefits were discussed in July 2008 and again in November 2008. The question of how to simplify the accounting for private entity defined benefit plans is the last significant area remaining for discussion at the February 2009 Board meeting (see Issue 27.3 and Issue 27.4 of Attachment 3 to this agenda paper).

Board decisions so far

9. Board decisions in July 2008:
    - All actuarial gains and losses and past service cost should be recognised immediately in profit or loss as proposed in the ED. In November 2008, the Board modified its July decision to permit recognition in other comprehensive income – with all private entities required to present a statement of comprehensive income. Deferral of actuarial gains and losses is prohibited.
    - The Board discussed whether, and in what circumstances, private entities might be allowed to measure the defined benefit obligation at a current termination amount, eg if information to apply the projected unit method as proposed in the ED was not available. No decision was 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.
10. Board decisions in November 2008 (the related issues shown in brackets are set out in Attachment 3 to this agenda paper):
    - The Board rejected a staff proposal (see Issue 27.3) to measure the defined benefit obligation at the current termination amount (essentially a vested benefit obligation) in some circumstances. However, the Board continued to believe that the defined benefit accounting under IAS 19 *Employee Benefits* should be simplified for private entities. 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 also decided tentatively:
  - o to allow two methods for recognising actuarial gains and losses - immediate recognition in profit or loss (as proposed in the ED) and immediate recognition in other comprehensive income. (Issue 27.1)
  - o to permit subsidiaries to recognise a charge based on a reasonable allocation of the group charge if the parent presents consolidated financial statements under the IFRS for Private Entities or full IFRSs. (Issue 27.4C)
  - o to 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. (Issue 27.5)
  - o not to require entities to divide the return on assets into an expected return and an actuarial gain or loss. (Issue 27.6)

11. Issues 27.3 and 27.4 (see Attachment 3) have been deferred by the Board to the February 2009 meeting.

Question sent to Working Group

12. The staff sought expert help from WG members in December 2008 by requesting input that may help the staff to develop a proposal to simplify the approach for measuring a private entity's cost and obligation under a defined benefit plan. The responses received are summarised in paragraphs 13 to 20 below. Some WG members commented on other areas of Section 27 that are not directly related to the measurement of defined benefit plans. Whilst these comments are not listed below, they will be considered by the private entity staff separately.

Summary of Working Group responses to email

13. 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.

14. **Respondent 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, the respondent 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. Private entities may not be able to do this calculation and get reliable results.
15. **Respondent 2**: There currently exists a differential reporting standard for private entities 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].
16. **Respondent 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.

17. **Respondent 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, which is Attachment 4). 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.

18. **Respondent 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.

19. **Respondent 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.

20. **Respondent 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 private companies:

- 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.

Discussion questions
1. What are WG members’ views on the various suggestions in the responses given above? 2. Do WG members have any other suggestions? 3. Does the WG have a ‘consensus view’ on whether and how defined benefit pension plan liability and cost measurement could be simplified for private entities?