IFRS

IASB Meeting Agenda reference **4B**

Staff Paper Date **October 2010**

Project	**Post-employment benefits**
Topic	**Recognition**

Objective

1. This paper provides:

   (a) Background, providing an overview of the proposals in the exposure draft *Defined Benefit Plans* (the ED) relating to the recognition of changes in defined benefit obligations and in plan assets (paragraphs 3 - 6).

   (b) An overview of the responses to the proposal to remove the corridor in the ED (paragraphs 7-11), together with staff analysis and a staff recommendation (paragraphs 12 - 16).

   (c) An overview of the responses to the proposal to recognise unvested past service costs (paragraphs 17 - 20), together with staff analysis and a staff recommendation (paragraphs 21 - 24).

   (d) A brief note on the interaction between the recognition of unvested past service costs and the recognition of termination benefits (paragraphs 25 - 27).

This paper has been prepared by the technical staff of the IASB for the purposes of discussion at a public meeting of the IASB working group identified in the header of this paper.

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.

The meeting at which this paper is discussed is a public meeting but it is not a decision-making meeting of the Board.

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.

Staff recommendation

2. The staff recommends that the Board confirms that entities should recognise:

   (a) all changes in the present value of the defined benefit obligation and in the fair value of plan assets when they occur (Question 1).

   (b) unvested past service cost when the related plan amendment occurs (Question 2). If so the staff also recommends the Board confirm its previous tentative decision to include in the definition of termination benefits only benefits provided in exchange for termination of employment.

Background

3. IAS 19 permits entities to recognise all gains and losses when they occur, or to leave actuarial gains and losses unrecognized if they are within a 'corridor' and to defer recognition of actuarial gains and losses outside the corridor. The ED (and the discussion paper that preceded it) proposed to remove that option so that entities would recognise all changes in defined benefit obligations and in the fair value of plan assets when those changes occur.

4. In the Basis for Conclusions, the Board expressed its view that immediate recognition provides the most useful information to users of financial statements because:

   (a) the resulting amounts in the statements of financial position and comprehensive income are relevant to users of financial statements and easier for them to understand. In contrast, deferred recognition can produce misleading amounts, for example:

      (i) an asset may be recognised in the statement of financial position, even when a plan is in deficit; or

      (ii) gains and losses that arise from economic events that occurred in past periods may be included in the statement of comprehensive income for the current period.

(b) it improves comparability across entities by eliminating the options allowed by IAS 19.

5. The Basis for Conclusions also expressed the Board's view that financial reporting will be significantly improved if entities recognise all changes in the fair value of plan assets and in the long-term employee benefit obligation in the period in which those changes occur. Accordingly, the exposure draft proposed to delete from IAS 19 the options in paragraphs 92–93D and 95 that allow an entity to defer the recognition of actuarial gains and losses.

6. The exposure draft also proposed that entities should recognise unvested past service cost in the period of a plan amendment because the attribution of unvested benefits to past service results in a liability as defined by IAS 19.

Removal of the corridor

Overview of comments received on the ED

7. Question 1 of the ED asked respondents the following:

> The exposure draft proposes that entities should recognise all changes in the present value of the defined benefit obligation and in the fair value of plan assets when they occur. (Paragraphs 54, 61 and BC9–BC12) Do you agree? Why or why not?

8. A significant majority of respondents agreed with the Board's reasons set out in the Basis for Conclusions and supported the proposal to recognise all changes in the present value of the defined benefit obligation and in the fair value of plan assets when they occur. In addition to the reasons given by the Board in the Basis for Conclusions, respondents also stated that they supported the proposal in the ED for the following reasons:

(a) The proposal is consistent with the Conceptual Framework.

(b) The proposal is consistent with US GAAP.

(c) The corridor method of accounting for defined benefit (DB) pension scheme surpluses and deficits is arbitrary and obscures information that is important to users of accounts.

(d) The proposal would reduce complexity and enhance consistency of reporting for defined benefit plans

9. Some respondents, particularly most pension funds and organisations with a public policy focus and some respondents from countries with 'hybrid' benefit plans disagreed with the proposal for the following reasons:

(a) Some state that the Board should not change the recognition requirements until it resolves the problems with the measurement of the defined benefit obligation which they argue does not reflect its nature. They note that the problems with the measurement of the defined benefit obligation are exacerbated by the requirement in IAS 19 that any plan that exposes the employer to risk is classified as defined benefit which results in what they consider to be inappropriate measurement of many plans that are 'nearly defined contribution'. Those who hold this view would prefer the Board to turn its attention to a comprehensive review now, or address the concerns regarding measurement and classification rather than proceeding with the proposals.

(b) Some are concerned about the introduction of volatility in an entity's statement of financial position. They argue that this:

(i) would make pensions appear riskier than other economically similar liabilities that are not measured at a current value.

(ii) could affect an entity's ability to meet loan covenants and to pay dividends.

(iii) might contribute to the pressure on defined benefit plans to close because entities do not want to accept the short-term capital market volatility that would result in their financial statements. Respondents fear adverse social consequences in countries where occupational defined benefit plans represent a significant part of social and pension arrangements.

(iv) might provide an incentive for entities to manage plan assets to reduce accounting volatility, rather than to meet the investment objectives of the plan.

10. In addition, some note that no new arguments have been raised that should cause the Board to revise its predecessor's reasoning in paragraph BC41 of current IAS 19:

> The Board found the immediate recognition approach attractive. However, the Board believes that it is not feasible to use this approach for actuarial gains and losses until the Board resolves substantial issues about performance reporting. These issues include:
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> (a) whether financial performance includes those items that are recognised directly in equity;
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> (b) the conceptual basis for determining whether items are recognised in the income statement or directly in equity;
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> (c) whether net cumulative actuarial losses should be recognised in the income statement, rather than directly in equity; and
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> (d) whether certain items reported initially in equity should subsequently be reported in the income statement ('recycling).
>
> When the Board makes further progress with those issues, it may decide to revisit the treatment of actuarial gains and losses.

11. Many respondents agreeing with the proposal in the ED were concerned about whether the proposals would require remeasurement of the net defined benefit asset or liability for interim reporting. These respondents argued that if frequent interim measurement was required, then the costs may not outweigh the benefits of the proposals. Some respondents also noted that the reduced preparation time for interim reports may result in an inability to perform the remeasurements or a reduction in the quality of information. The staff plans to consider the issues raised on interim reporting at a future meeting.

Staff analysis and recommendation

12. The Board has previously considered the concerns raised by constituents in finalizing the proposals in the ED as noted in the following paragraphs of BC11:

    (a) *Measurement model requires further work* - The Board agrees that several aspects of the measurement model require investigation and that investigation might lead to changes in measurement. However, in the Board's view, deferred recognition is not a necessary component of the existing measurement model for defined benefit plans. Moreover, failure to recognise all gains and losses during the period means that the amount reported as a net defined benefit liability (asset) is not a faithful representation of the entity's obligation. In addition, the Board believes that any future review will retain the fundamental conclusion that an entity must account for its obligation to provide benefits as a result of services already rendered by employees. Consequently, the Board believes that proposals for immediate recognition need not be delayed until further work on the measurement model is completed.

    (b) *relevance of information*: In the Board's view, it is not inevitable that future gains or losses will occur and that they will offset past losses or gains. Indeed, if the actuarial assumptions at the end of the reporting period are valid, future fluctuations would offset each other and would not offset past fluctuations.

    (c) *volatility*: The Board believes that a measure should be volatile if it faithfully represents transactions and other events that are themselves volatile, and financial statements should not omit such information. The Board agrees that information should be presented in a way that is most useful to users of financial statements. The Board therefore proposes to require a presentation that permits users of financial statements to isolate remeasurements of the entity's net defined benefit liability (asset) (see paragraphs BC35–BC44).

(d) *behavioural and social consequences*: In the Board's view, it is not the responsibility of accounting standard-setters to encourage or discourage particular behaviour. Their responsibility is to set standards that result in the provision of relevant information that faithfully represents an entity's financial position, financial performance and cash flows so that users of that information can make well-informed decisions.

(e) *potential effect on debt covenants and dividend payment*: In the Board's view, it is up to the entity and the holder of a covenant to determine whether to insulate a debt covenant from the effects of a future IFRS or to determine how they might renegotiate any existing covenant so that it reflects only changes in an underlying financial condition rather than those that result from changes in reporting.

13. The staff does not believe that the responses to the proposals provide any additional information that invalidate the views stated above.

14. The staff acknowledges that the Board has yet to answer some general questions about performance reporting in its financial statement presentation project. However, the Board has previously decided that it should address presentation of post-employment benefit costs in this project now, rather than risk delaying progress on immediate recognition by waiting for the financial statement presentation project to address performance reporting.

15. Some respondents were concerned that the benefits of the proposals would not outweigh the costs if the Board were to undertake further projects on post-employment benefits that would cause them to have to change their systems again in the near future. However, the scope and timing of any future pensions project is as yet unclear. Any decisions taken in this project could be in place for several years.

16. Accordingly, the staff does 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.

Question 1
Does the Board confirm the ED proposal to recognise all changes in the present value of the defined benefit obligation and in the fair value of plan assets when they occur?

Recognition of unvested past service cost

Comments received on the ED

17. Question 2 of the ED asked respondents the following:

> Should entities recognise unvested past service cost when the related plan amendment occurs? (Paragraphs 54, 61 and BC13) Why or why not?

18. In general, those that answered yes to question 1 also answered yes to question 2. A majority of respondents agreed with the Board's views and supported the proposal to recognise unvested past service cost at the time of the plan amendment. Other reasons for supporting the proposal in the ED included:

    (a) this recognition treatment would result in consistent recognition of all unvested costs, both current service and past service.

    (b) Some respondents believe the distinction between vested and unvested benefits in the current standard is artificial and confusing and support the removal of different accounting based on the distinction.

19. Respondents that disagreed with the removal of the corridor also tended to disagree with the recognition of unvested past service cost for the same reasons mentioned in paragraph 9 above. However some that agreed with the removal of the corridor nonetheless disagreed with the proposal in Question 2 for the reasons set out below:

    (a) The majority of plan amendments are initiated with the intent to benefit future periods. Therefore the proposal is not consistent with the principle in IAS 19 that employee benefit expense is recognised in the period when the employee must provide the service needed to qualify for the benefit. It would be more consistent with that principle to require recognition of unvested past service cost over the remaining service periods until vesting.

(b) The proposals would discourage entities from improving benefits that vest over future periods and encourage entities to reduce benefits if they are required to recognise the cost immediately.

(c) The Board appears to indicate that it does not believe this proposal to be the best conceptual answer which is reflected in other IFRSs. Paragraph 2.20 of the discussion paper states that recognising unvested past service cost over the vesting period would be consistent with what the Board thought were the best conceptual answers when it adopted those answers in IFRS 2 *Share Based Payments*. The benefit of the change would not outweigh the costs of implementing it if the Board were to reverse its decision in a future post-employment benefits project.

(d) The proposal may provide potential for arbitrage. For example, assume that all of the employees of an entity have been working for the entity for five years or longer as at the beginning of the year and the entity intends to pay every employee an additional bonus, if the employees stay with the entity for 3 further years. If unvested past service costs are recognised immediately, the entity can, by offering a bonus that includes a past service period, choose how much of the total expense is recognised in the period of the bonus grant and both periods following. If the entity offers a bonus with a five year past service period, 6/8 of the total expense is recognised in the first year and only 1/8 in both the following periods. If the entity includes no past service period instead, the entity would recognise 1/3 of the total expense every year. Yet, there would be no difference in substance between the two arrangements.

20. In addition to the above comments, some respondents requested clarification of when a plan amendment has ‘occurred’. Possibilities suggested include when the plan amendment is adopted, when the plan amendment is communicated to affected members, or when the plan amendment is effective.

Staff analysis and recommendation

21. The Board has previously acknowledged that it would be consistent with other IFRSs to attribute changes in unvested benefits arising from plan amendments to future service from employees over the period(s) until the amended benefits vest. For example, IFRS 2 *Share-based Payment* regards increases in benefits with a vesting period as attributable to employees’ future services until vesting date.

22. 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 benefits in accordance with a benefit formula, then unvested past service cost is a liability in accordance with IAS 19. The alternative view (ie 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. However, as explained in the Basis for Conclusions to the ED, that approach would result in deferred recognition of an amount that is regarded as a liability in IAS 19.

23. The staff agrees that the proposal may introduce an opportunity for accounting arbitrage, however the alternative approach of recognizing unvested past service cost over the period of plan amendment may also be open to accounting arbitrage. This is because any approach to attributing unvested benefits to periods of service is arbitrary. However, as explained in the paragraph above, the proposal in the ED is more consistent with the definition of a liability in IAS 19.

24. The staff will consider the concerns about defining when a plan amendment occurs next month together with the discussion of the presentation of the effects of settlements and curtailments.

Question 2
Does the Board confirm the proposal in the ED to recognise unvested past service costs when the related plan amendment occurs?

Termination benefits

25. We intend to finalise amendments to the termination benefits section of IAS 19 together with the amendments to IAS 19 resulting from this ED. Those amendments were originally proposed in 2005 and intended to align the recognition point of termination benefits between IFRSs and US GAAP. In January 2010 the Board tentatively decided to:

    (a) amend the definition of termination benefits to include only benefits provided in exchange for termination of employment and not include benefits provided in exchange for employee service.

    (b) require an entity to recognise termination benefits when it no longer has the ability to withdraw an offer of those benefits.

26. US GAAP addresses benefits provided by an entity if employees stay for a period before termination (a stay bonus) in US Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) topic 420 *Exit or Disposal Cost Obligations* (FASB ASC Topic 420). Topic 420 requires these benefits to be recognised over the future service period. The January 2010 decision on termination benefits would result in the same recognition under existing IAS 19. However IAS 19 would label these benefits as post-employment benefits, whereas Topic 420 labels them as termination benefits.

27. If the Board confirms the proposal to recognise unvested past service cost immediately, a stay bonus would be recognised over the future service period if

it is provided by amending an existing plan and the benefit formula attributes those benefits to future service. However, if the benefit formula attributes benefits to prior service, then those benefits would be recognised as past service cost. This is inconsistent with their recognition under Topic 420, however their recognition will be consistent with other post-employment benefits in IAS 19.

Question 3

If the Board decides to confirm proposal in the ED to recognise unvested past service costs when the related plan amendment occurs, does the Board confirm its previous tentative decision to include in the definition of termination benefits only benefits provided in exchange for termination of employment?