

Post-employment benefits convergence project summary

Contribution to the Electronic Discussion Group on Pensions (IMF)

By Anne McGeachin, Project Manager for the IASB – June 24, 2003

In June 2002, the International Accounting Standards Board (the “Board”) agreed to add a limited convergence project on post-employment benefits to its active agenda. The objective of the project is not to consider all aspects of accounting for post-employment benefits. Rather it is to build on the principles that are common to most existing national standards on this topic and to seek improvements to International Accounting Standard (IAS) 19 in certain specific areas.¹

Scope

The scope of the project was discussed at the June 2002 meeting and extended at the September 2002 meeting. It comprises the following issues:

- Recognition of actuarial gains and losses.
- The asset ceiling.
- The impact of the asset ceiling, if any, on the components recognised in income.
- The expected return on assets.
- The definitions of defined benefit plans, defined contribution plans and plan assets.
- The allocation of cost to accounting periods.
- The net presentation in the balance sheet of plan assets and plan liabilities.
- Additional disclosures related to plan assets (depending on decisions made on some of the matters above).
- A review of the requirements in Financial Accounting Standard (FAS²) 106, Employers’ Accounting for Postemployment Benefits, and FAS 112, Employers’ Accounting for Postretirement Benefits Other Than Pensions, to consider whether additional guidance in these standards should be included in IAS 19.
- Mitigation of problems that may arise from the immediate recognition of actuarial gains and losses (if the Board proposes such a treatment):

¹ *Moderator:* Information on the IASB is accessible on its web site at:

<http://www.iasb.org.uk/cmt/0001.asp>

² *Moderator:* FAS are the standards elaborated by the US Financial Accounting Standards Board (FASB). Those are accessible on the FASB web site at: <http://www.fasb.org/st/>

presentation of actuarial gains and losses under the proposals for performance reporting, presentation of the pension asset or liability in the balance sheet and multi-employer exemptions.

In February 2003, the Board discussed whether to extend the project to a comprehensive project on post-employment benefits. It agreed that such a project was too big an undertaking at present but that a project plan should be developed for future consideration, preferably as a joint project with other standard setters. It also agreed that the issue of whether the measurement of the plan liabilities should be based on expected final salary or current salary should not be included in the scope of the current project.

Recognition of actuarial gains and losses

The Board tentatively agreed that actuarial gains and losses should be recognised immediately, ie that the corridor and spreading options within IAS 19 should be removed. However, it was accepted that such a proposal could not be taken forward until the proposals for performance reporting were finalised.

The asset ceiling

The Board considered whether there should be a limit on the amount that can be recognised as an asset in respect of a surplus in a defined benefit plan. The Board agreed that the exposure draft should state the principle that an entity should recognise an asset that represents the benefit it can derive from the surplus. The exposure draft should go on to explain that:

- (a) in some circumstances, the entity has control over the plan to the extent that the plan assets are essentially assets of the entity. In these cases, the net presentation of the plan assets and plan liabilities in the entity's balance sheet is equivalent to a one-line consolidation and the benefit that can be derived from a surplus is the full amount of the surplus
- (b) in other cases, the plan assets are not controlled by the entity. Rather the entity has a beneficial interest in the plan. In these cases, the entity can derive benefit from the surplus in the following ways:
 - i. through its rights to refunds and reductions in future contributions,
 - ii. through its rights to fund increased benefits to current and future employees (no value should be ascribed to the entity's right to fund increased benefits to past employees) and
 - iii. through its rights not to fund future losses in the plan to the extent that the losses will be absorbed by the surplus.

The Board noted that the third element ((b)(iii)) could, in theory, be valued in a similar way to a call option – its value depends on expectations of future changes in value of assets and liabilities in the plan. The Board agreed that the exposure draft should state that the third element will rarely be capable of reliable measurement.

The Board considered whether guidance was needed on how to apply elements (i) and (ii) of the hierarchy. It agreed that guidance was needed, but that it should not form part of the standard. The Board agreed the following:

The entity's rights to refunds and reductions in future contributions

- (a) the entity should determine the expected value of rights to refunds and reductions in future contributions
- (b) the expected value of the entity's rights to reductions in future contributions should be calculated as:
 - i. the present value of the liability expected to arise from future service by current and future plan members *less both*
 - ii. the present value of future employee contributions that would be expected if there were no surplus and
 - iii. the present value of the minimum contributions that the entity is required to make despite the existence of the surplus.
- (c) in measuring items b(i) and (ii):
 - i. the actuarial assumptions should be the same as those used to measure the defined benefit obligation, ie the best estimate
 - ii. the benefits promised under the plan should be assumed to be the same as those reflected in the measurement of the defined benefit obligation
 - iii. the assumptions about the size and demographic workforce should be consistent with management's budgets/forecasts. Beyond the period covered by the budgets/forecasts, the workforce should be assumed to be steady unless there is external evidence to support different assumptions
- (d) in measuring item b(iii), where the measurement basis underlying a requirement for the entity to make contributions is legally prescribed, the required contributions to be deducted in arriving at the asset should be based on that legally prescribed measurement basis.
- (e) in measuring items b(i), (ii) and (iii), the discount rate should be the same as that required by IAS 19 for the defined benefit obligation, without any adjustment for the uncertainty relating to reductions in future contributions

The entity's rights to fund increased benefits to current and future employees

- (f) in determining the value of the entity's rights to fund increased benefits to current and future employees:
 - i. IAS 19 should note that plan trustees might require increases in benefits to past members as well as current members and/or additional contributions to be made to the plan to cover such increases. Such requirements would affect the amount of the surplus which the entity had the right to use to give benefits to current (and future) members
 - ii. as noted above, no asset should be recognised in respect of the entity's ability to fund increases in benefits to past employees
 - iii. the assumptions about the future size of the workforce should be consistent with those recommended in determining the value of the reductions in future contributions (see (c)ii above)

The presentation of components of cost in the income statement, including the expected return on assets

IAS 19 requires the total change in value of plan assets to be split into an expected return and the difference between the expected return and the actual return. The expected return is currently reported in income and the difference between the expected return and actual return is treated as an actuarial gain and loss, the recognition of which is currently allowed to be deferred. The Board had previously agreed that there should be no deferral of actuarial gains and losses (see above).

The Board agreed that it wished to present changes in value of the defined benefit obligation as follows:

- (a) service cost, as business activity income before remeasurement
- (b) actuarial gains and losses arising from changes in assumptions about the benefit cash flows, as business activity remeasurement
- (c) interest cost on the benefit obligation, as financing activity before remeasurement
- (d) actuarial gains and losses on the benefit obligation arising from changes in interest rates, as financing activity remeasurement
- (e) settlements and curtailments, as business activity remeasurement.

The Board also agreed that it wished to present changes in the value of plan assets in the section of business activities relating to financial assets. Hence, the changes in the value of plan assets would not be offset against the changes in value of the defined benefit liability shown in the financing section.

Finally, the Board tentatively agreed that all changes in the value of plan assets would be presented as remeasurements. No interest income on plan assets would be

presented as income before remeasurement. That decision was confirmed after further discussion at a subsequent Board meeting.

The presentation of the impact of the asset ceiling

The Board agreed that any income or expense resulting from the application of the asset ceiling test should be presented in the income statement as a remeasurement in the financial assets sub-section of business activities. It should be disclosed separately in the notes from the other components of the defined benefit cost.

The definitions of defined benefit plans, defined contribution plans and plan assets

The Board considered the definitions of defined contribution plans and defined benefit plans. It agreed to amend the definition of defined contribution plans to:

- (a) address a potential for misinterpretation in the existing definition in IAS 19 relating to the status of overfunded defined benefit plans and
- (b) to classify plans with upside risk for employers as defined benefit plans.

The Board also considered the definition of plan assets. It agreed not to amend the definition.

Consolidation and balance sheet presentation issues

The Board discussed whether defined benefit plans should be consolidated, what assets and liabilities arise from an entity's participation in a defined benefit plan and how they should be presented in the balance sheet. The Board agreed that the question of whether and when defined benefit plans should be consolidated was too big an issue for this limited convergence project and should instead be tackled in the consolidations project.

The allocation of costs to periods of service

The Board reconsidered its earlier decision that unvested benefits should be recognised on a straight-line basis over the vesting period and reverted to the current requirements of IAS 19, ie that benefits should be recognised according to the benefit formula (except when service in later years will lead to a materially higher level of benefit than in earlier years in which case straight-line allocation is required). The Board noted that a consequence of this would be that some increases in unvested benefits would be allocated to past periods, giving rise to a past service cost. The Board confirmed its previous decision that any such past service cost should be recognised immediately, rather than over the vesting period (as currently required by IAS 19).

Disclosure of the classes of assets held by the defined benefit plan

The Board agreed that disclosure should be required of the broad asset classes held by the pension plan. The classes would be determined using the principle in IAS 32.46, that financial instruments should be grouped into classes that are appropriate to the nature of the information disclosed, taking into account matters such as the

characteristics of the instruments. The staff were instructed to consult on any practical problems that might arise from such a requirement.

Guidance in US literature

The Board considered the differences between the guidance provided in IAS 19 and FAS 106 *Employers' Accounting for Postretirement Benefits Other Than Pensions* and decided:

- to include in an appendix or implementation guidance to IAS 19 guidance on the identification of a substantive non-pension post-employment benefit plan similar to the guidance in FAS 106
- to include in an appendix or implementation guidance to IAS 19 guidance on the selection of assumptions unique to health care post-employment benefit plans similar to the requirements and guidance in FAS 106, to the extent that the requirements and guidance in FAS 106 do not conflict with IAS 19
- to amend IAS 19 to require the recognition of potential changes in state health care benefits where the state benefits have been 'substantively enacted' (rather than the present requirement for reliable prediction), similar to the requirements of IAS 12 *Income Taxes*
- to require an analysis of the sensitivity of health care post-employment benefit plans to changes in the assumed health care cost trend rates
- to review whether the sensitivity of other post-employment benefits plans to key assumptions such as inflation should be disclosed in accordance with the proposals in [Draft] IAS 1 *Presentation of Financial Statements*
- to require the separate disclosure of post-employment benefit plans where the plans are subject to materially different risks, instead of the present encouragement of such disclosures.

The position of the defined benefit asset/liability in the balance sheet

The Board agreed that the defined benefit asset/liability should be prominently and separately presented in the balance sheet because of its significance and sensitivity to changes in market prices and estimations.

Availability to group companies of the exemption from defined benefit accounting for participants in multi-employer plans

The Board agreed that the individual entities within a group should be entitled to an exemption from defined benefit accounting similar to that available for participants in multi-employer plans.