

IASB Proposes Changes to IAS 19

As the Accounting for Retirement Plans Evolves

Bulletin

Executive Summary

In a further step in the evolution of the accounting for retirement benefits, the International Accounting Standards Board (IASB) has issued its long-awaited Exposure Draft (ED) of proposed changes to IAS 19, *Employee Benefits*. If adopted as proposed, employers would be required to:

- Immediately recognise all changes in the funded position of retirement plans — gains and losses arising from experience differing from what was assumed, changes in assumptions, investment gains and losses on plan assets, and the effect of plan changes
- Replace interest cost and the expected return on plan assets with a measure of net interest income/expense on the plan surplus or deficit, with this interest income or expense measured based on the plan's discount rate
- Consider expected future plan administration costs in measuring the defined benefit obligation (DBO) and the plan's service cost
- Disaggregate the components of retirement plan costs into service cost, net interest income/expense and remeasurement components for purposes of reporting the costs in the comprehensive income statement. The remeasurement component, which would include gains and losses (including investment returns in excess of or less than the implied investment returns in the net interest income/expense calculation) and the effect of settlements, would be reported in other comprehensive income (OCI), while the service cost and net interest income/expense components would be reported separately in profit and loss (P&L) as employment cost and financing cost, respectively
- Expand their disclosures to provide more insight about the nature of the plans and associated risks, including sensitivity analysis, development of demographic assumptions, fair-value measurement of the plans' assets and cash flows

The proposed changes would affect entities differently, depending on the nature of their plans and current

accounting policies, but would often result in some or all of the following:

- Lower net income
- Less volatility in net income
- Higher balance sheet liability or lower balance sheet asset for retirement benefits
- Greater volatility in the balance sheet asset or liability
- More onerous disclosure requirements

Although the proposals are considerably watered down from the initial targeted changes to IAS 19, they could have a significant effect on many plan sponsors' financial reporting and the information disclosed about their benefit plans.

Comments on the ED are due 6 September 2010. Following that, the IASB will redeliberate the issues, taking into consideration the comments received. The resulting amendment to IAS 19 is expected to be issued in mid-2011 with a 1 January 2013 effective date. The new rules would require restatement of prior periods' financial statements and financial information presented for comparative purposes.

Background

The accounting for retirement and other post-employment benefits is in an evolutionary state. Users of financial statements have expressed concerns about employers' transparency in reporting their benefit obligations under current accounting rules, the risks associated with their benefit plans, and the effect of the benefit plans on the entities' financial position and income. In addition, the increased prevalence of less traditional retirement plan designs has led to questions about the measurement of retirement obligations. In April 2008, the IASB issued a Discussion Paper laying out its preliminary thinking about short-term changes to IAS 19 that should be made in response to some of those concerns. The Discussion Paper was the first part of a more comprehensive reexamination of the accounting for, and financial reporting of, postemployment benefit promises.

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The Discussion Paper proposed consideration of:

- Elimination of the option to delay recognition of changes in the fair value of plan assets and benefit obligations
- Introduction of, and fair-value accounting for, the notion of “contribution based” promises*
- Valuation of postemployment benefits that give employees the higher of a defined benefit promise and a contribution-based promise
- Approaches for presenting postemployment benefit costs on the comprehensive income statement

After considering comments on the Discussion Paper, the IASB shortened the list of short-term targeted changes to IAS 19. Those changes are focused on recognition and presentation of changes in the DBO and plan assets, expanded disclosures and miscellaneous cleanup issues. The ED just issued addresses those changes.

Like the U.S. Financial Accounting Standards Board (FASB), the IASB believes greater transparency is achieved by immediately recognising changes in the funded position of retirement plans on the plan sponsor’s balance sheet and comprehensive income statement, and enhancing financial statement presentation and disclosures. The IASB’s ED more closely aligns the balance sheet effects with the balance sheet effects reported under U.S. GAAP — but the income statement effects would be vastly different between IAS 19 and U.S. GAAP

The second phase of the IASB’s project is intended to be a comprehensive reconsideration of the accounting for employee benefits. Work on that phase has not yet commenced and is expected to take several years to complete.

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What Would Change?

The ED issued by the IASB in April 2010 proposes several substantive changes to IAS 19.

Immediate recognition of gains and losses and plan changes

Currently	Proposed
Gains and losses may be recognised either immediately (through P&L or OCI) or on a delayed basis. At a minimum, plan sponsors must amortise the net gain or loss outside a corridor (defined as 10% of the greater of the DBO or the fair value of plan assets) over participants’ future service periods.	All gains and losses would be recognised immediately through OCI.
The change in the DBO due to plan changes affecting vested benefits is recognised immediately; the effect of plan changes affecting nonvested benefits is amortised over future periods to the date the amended benefits vest.	The entire change in the DBO due to plan changes would be recognised immediately through P&L.

Towers Watson Observations

Immediate recognition of gains and losses is intended to improve transparency in entities’ financial reporting. The IASB’s proposal to recognise gains and losses as a remeasurement effect in OCI rather than P&L would isolate the effect of unexpected changes in the DBO and fair value of plan assets, which is useful to financial statement users. By eliminating the P&L volatility arising from those unpredictable changes, year-to-year comparisons of profitability would be enhanced.

For entities that currently delay recognition of gains and losses (for example, by using the “10% corridor” option under IAS 19), the move to immediate recognition of gains and losses would be a significant change that could dramatically increase their balance sheet liability or reduce the asset recognised, and lead to substantially more balance sheet volatility.

Immediate recognition of all plan changes reflects the views expressed by most respondents to the Discussion Paper. However, it would result in more P&L volatility for plans providing benefits that don’t vest until retirement, such as retiree medical benefits.

* A contribution-based promise was defined in the Discussion Paper as a benefit based on an accumulation of actual or notional contributions, which may include a promised return linked to the return from an asset, a group of assets or an index. Examples of benefit arrangements that would have been affected include cash balance plans, career-average pay plans and plans with a minimum guaranteed return.

Replace interest cost and the expected return on plan assets with a measure of net interest income or expense on the plan deficit or surplus

Currently	Proposed
<p>Interest cost reflects the expected increase in the DBO due to the time value of money.</p> <p>The expected return on plan assets reflects the expected increase in the fair value of assets due to investment performance.</p>	<p>Net interest income or expense would measure the expected change in the surplus or deficit due to the time value of money; the discount rate* would be used to measure the effect of the passage of time.</p>

Towers Watson Observations

The proposed approach reflects the IASB’s concern about the significant judgment required by entities in selecting their assumption about the expected rate of return on plan assets and its relationship to the discount rate. The net interest approach effectively assumes an expected rate of return on plan assets equal to the discount rate and ignores the plan’s asset allocation. The difference between the actual return on plan assets and the discount rate-based estimated return would be included in the gains and losses recognised through OCI.

In most cases, the net interest approach would reduce net income, since a plan sponsor’s P&L would not benefit from the expectation of higher returns on riskier investments. This could encourage more conservative investing and de-risking strategies. Over the long term, such a reaction would likely increase the employer’s real cost of providing defined benefits.

On the other hand, higher asset returns realized from riskier investment strategies would improve the plan’s funded position and reduce the future net interest charge and the employer’s real cost of providing the benefits.

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Consider expected future plan administration costs in measuring the DBO and the plan’s service cost

Currently	Proposed
<p>Plan administration costs, including taxes payable by the plan on contributions from the plan sponsor, may be reflected as a reduction in the return on plan assets or included in the actuarial assumptions used to measure the DBO.</p>	<p>The cost of administering claims and benefit payments, as well as taxes payable by the plan on contributions from the plan sponsor, would be included in the actuarial assumptions used to measure the DBO.</p>

Towers Watson Observations

Common practice has been to expense plan administration costs, either as a reduction in the actual and expected asset return or through a direct charge to P&L. An explicit requirement to include assumed administrative costs in measuring the DBO, rather than accounting for the costs in the current period, could increase the DBO, service cost and net interest expense by as much as a few percent. The effect on net income will depend on the company’s current practice of expensing such costs.

The Basis for Conclusions states that “IAS 19 requires an entity to estimate the ultimate cost of providing long-term employee benefits.” It is our understanding, for example, that these costs would likely encompass not only the costs of internal and external benefits administration, but also insolvency premiums, such as those charged by the U.S. PBGC, U.K. PPF, Ontario PBGF, Swedish PRI *Pensionsgaranti* and German PSV, and the regulatory and compliance costs associated with administering a plan.

* Discount rates are based on market yields on high-quality corporate bonds; where there is no deep market in such bonds, government bond yields are used.

Disaggregate components of postemployment benefit cost into:

- An employment component (current and past service cost, as well as curtailment effects), which would be included in operating costs
- A financing component (net interest income/expense), which would be included in financing costs
- A remeasurement component (actuarial gains and losses, including settlement effects and changes in the asset ceiling), which would be shown separately in the OCI section of the statement of comprehensive income

Currently, IAS 19 does not prescribe how the components of benefit cost are to be presented in the financial statements, that is, as a single amount or separate components. The proposed disaggregation reflects the board's current views on financial statement presentation.

Specifically, the IASB and FASB have undertaken a joint project to address the presentation and display of information in the financial statements. In Discussion Papers issued in October 2008 and subsequent deliberations, the boards have agreed that information in the financial statements should be disaggregated by function and nature to enhance the usefulness of the reported amounts. In addition, the boards have agreed that comprehensive income — P&L plus OCI — should be reported in a single statement of comprehensive income (SCI). (An ED on the proposed SCI is imminent; the final standard is expected to be issued in late 2010. An ED on financial statement presentation overall is expected to be issued in May, with a final standard expected to be issued in mid-2011.)

Towers Watson Observations

The proposed disaggregation of the components of benefit cost — into employment, financing and remeasurement components — should enhance the comparability and usefulness of the line items in the SCI. Including remeasurement effects in OCI, while service and financing costs affect P&L, reflects the differing predictive values of those amounts when analyzing financial statements.

Expanded disclosures,* including sensitivity information and information useful in assessing liquidity risk and market risk associated with the plan assets

Towers Watson Observations

IAS 19 currently distinguishes between postemployment benefits, such as pension and retiree medical benefits, and long-term employee benefits, such as long-term disability and long-service benefits. The ED proposes redefining long-term employee benefits to encompass postemployment benefits, and replacing the term “postemployment” with “long-term” employee benefits. Having just one category should be simpler in practice, but means that the disclosures would no longer be limited to postemployment benefits.

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* The appendix provides a description of the proposed disclosures and observations.

Other miscellaneous changes

The ED also incorporates IFRIC 14, *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and Their Interaction*, into IAS 19, and includes other clarifications and amendments intended to address issues that have arisen in practice:

- Expected salary growth should be considered in determining whether a benefit formula attributes a materially higher level of benefit to later years of service (i.e., the formula is backloaded).
- Risk sharing (i.e., the benefits of a plan surplus or the cost of a plan deficit is shared by various parties, such as the employer and current and/or former employees, including retirees) and/or conditional indexation features (e.g., an increase is conditioned on the plan's funded status) should be considered in measuring the DBO.
- The distinction between short-term and long-term employee benefits depends on the timing of the expected settlement (rather than when an employee would be entitled to the benefit).

Towers Watson Observations

Consideration of expected salary growth in determining how benefits are to be attributed to years of service would increase the DBO and net interest expense for career-average pay plans and some cash balance plans. In many cases, the service cost would also increase.

“Companies should analyse and understand the implications of the proposed changes on their financial statements, and the effort and cost that would be incurred to prepare the proposed disclosures.”

Timing

Comments on the ED are due 6 September 2010. Following that, the IASB will redeliberate the issues. The final amendment to IAS 19 is expected to be issued in the second quarter of 2011, with a 1 January 2013 effective date. It is expected to require restatement of prior periods' financial statements and financial information presented for comparative purposes.

To Sum Up

At their core, the proposed changes represent an evolution of IAS 19 intended to improve transparency, eliminate choice and make short-term fixes. Although substantially more limited in scope than initially contemplated in the Discussion Paper, the proposed changes could still significantly affect plan sponsors' financial reporting and the information disclosed about their benefit plans.

A more comprehensive reconsideration of the framework for accounting for employee benefits is still several years off.

What Should Employers Do Now?

Companies should analyse and understand the implications of the proposed changes on their financial statements, and the effort and cost that would be incurred to prepare the proposed disclosures.

Comments on the changes proposed by the IASB are given due consideration in formulating the final changes. It is therefore important that employers, investors and other interested parties provide their perspectives on the proposed changes and make suggestions for improvement. In particular, specific information about employers' costs of making the proposed changes and providing the proposed disclosures and the corresponding benefits to analysts and investors is encouraged, and will aid the board and staff's thinking as they develop the final standard.

Appendix

The IASB has proposed the following disclosures (proposed new disclosure requirements are shaded).

ED	Description	Observations
Disclosure objectives		
125A	Disclosures should: a) Explain characteristics of defined benefit plans b) Identify and explain amounts in financial statements c) Describe effect on future cash flows	More focus on describing risks relative to entity's financial statements
125B	Assess need for disaggregation (e.g., plans with different geographies, plan characteristics, regulatory environments or funded status)	Emphasises need for disclosures to be disaggregated to distinguish plans with materially different risks
Characteristics of defined benefit plans		
125C	Characteristics of defined benefit plans: a) Information about plans, including type of benefits, regulatory environment (e.g., minimum funding requirements), third-party governance, restrictions on surplus recovery and description of calculation of economic benefit b) Narrative description of risk exposures c) Narrative description of amendments, curtailments and non-routine settlements	Expands current requirements to provide more insight about amounts recognised and risk exposures
Identify and explain amounts in financial statements		
125D	a) Reconciliation of changes in defined benefit asset/liability (reconciling changes in plan assets/DBO/asset ceiling separately) b) Reconciliation of changes in any reimbursement rights and relationship to DBO	Similar to current practice, with addition of reconciliation of changes in asset ceiling
125E	Description of components to be included in reconciliations in 125D	Similar to current requirement
Other information about amounts in financial statements		
125F	Disaggregation of fair value of plan assets into classes based on risk and liability characteristics, and quoted market price versus no quoted market price	Expands current requirement to provide more insight on risk and valuation basis of plan assets
125G	Actuarial assumptions used to determine the DBO and process used to determine demographic assumptions	Expands on current requirement to provide insight on demographic assumptions
125H	DBO with no allowance for salary growth	Measure of interest to financial statement users
Amount timing and variability of future cash flows		
125I	a) Sensitivity analysis for each key assumption showing the effect on service cost and DBO b) Methods used to determine sensitivity and limitations of those methods c) Changes from previous period	Intended to supplement disclosure of actuarial risk (paragraph 125C(b))
125J	Asset/liability matching strategies (e.g., annuities or longevity swaps)	Provides insight on risk mitigation
125K	Factors that could cause contributions over the next five years to differ significantly from service cost (e.g., extent and duration of any contribution holiday due to surplus or additional contributions needed to eliminate the deficit)	Intended to provide more insight than disclosure of future contributions, which generally cannot be reliably estimated

Appendix (cont)

ED	Description	Observations
Multiemployer plans		
33A	<p>If the entity participates in a defined benefit multiemployer plan:</p> <ul style="list-style-type: none"> a) Description of funding arrangements b) Extent to which the employer can be liable for other participating employers' obligations c) Total number of active, deferred and retired members in the plan and employer's proportion of each d) Agreed surplus/deficit allocation on windup or amount payable on withdrawal 	Provides insight about risks associated with participation in multiemployer plan
	<ul style="list-style-type: none"> e) If the employer accounts for its proportionate share of the defined benefit multiemployer plan, provide the disclosures required by 125A-125K f) If the employer accounts for its participation as if it were a defined contribution plan <ul style="list-style-type: none"> i) The fact that the plan is a defined benefit plan ii) Why sufficient information is not available to enable defined benefit accounting iii) Expected contributions for next five years iv) Surplus or deficit in plan that may affect the amount of future contributions, including basis used to determine surplus 	<p>Conceptually similar to current requirement, but proposed defined benefit plan disclosures are more extensive than currently required</p> <p>Similar to current requirements, with addition of expected future contributions</p>

A number of existing disclosures would be eliminated, as they would no longer be necessary or would be apparent from other disclosures:

- Accounting policy for recognising gains and losses
- DBO for unfunded plans and DBO for wholly or partly funded plans
- Reconciliation of funded status to amount recognised on balance sheet
- Components of cost
- Plan assets invested in the plan sponsor's financial instruments and assets, or property used by the plan sponsor

Other disclosures that have been proposed to be eliminated include:

- Cumulative amount recognised through OCI for gains and losses and the asset ceiling

- Five-year history of the DBO, fair value of plan assets, surplus or deficit, and experience gains/losses

Observation: Standard setters often propose more extensive disclosure requirements than they will ultimately seek to require, in an effort to get feedback from financial statement users and preparers on the most useful information and the cost of providing that information. Therefore, it is important for interested parties to assess the cost versus benefit of the proposed new disclosures as well as the disclosures proposed to be eliminated and provide comments to the IASB based on that analysis.

While much of the disclosure information could be prepared before year-end, certain of the proposed disclosures would require a nontrivial effort at or after the end of the sponsor's fiscal year.

About Towers Watson

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