Applying IFRS

IAS 19 *Employee Benefits* — revised June 2011

Implementing the 2011 revisions to employee benefits

November 2011

Ernst & Young
Quality In Everything We Do

In this issue:

What you need to know

- Revisions to IAS 19 *Employee Benefits* published by the IASB on 16 June 2011 result in significant changes in accounting for defined benefit pension plans. There are also a number of other changes, including modification to the timing of recognition for termination benefits, the classification of short-term employee benefits and disclosures of defined benefit plans.
- The accounting options available under current IAS 19 have been eliminated, resulting in increased comparability between the financial statements of IFRS reporters.
- Highlights from the changes for defined benefit plan accounting include:
  - Actuarial gains and losses are now required to be recognised in other comprehensive income (OCI) and excluded permanently from profit and loss.
  - Expected returns on plan assets will no longer be recognised in profit or loss. Expected returns are replaced by recording interest income in profit or loss, which is calculated using the discount rate used to measure the pension obligation.
  - Unvested past service costs can no longer be deferred and recognised over the future vesting period. Instead, all past service costs will be recognised at the earlier of when the amendment/curtailment occurs or when the entity recognises related restructuring or termination costs.
- These revisions are effective for annual periods beginning on or after 1 January 2013, retrospectively, with very few exceptions. Early application is permitted.

Introduction

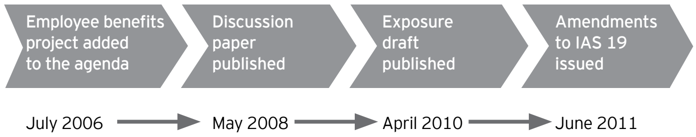
In June 2011, the International Accounting Standards Board (IASB or the Board) issued revisions to IAS 19 *Employee Benefits* (the 'revisions', 'IAS 19R' or 'revised standard') that provide significant changes in the recognition, presentation and disclosure of post-employment benefits. IAS 19R also changes the accounting for termination benefits and short-term employment benefits, along with a number of more minor clarifications and re-wording of the standard.

The impact of these revisions could range from significant to immaterial. This will depend on the type of employee benefits an entity provides, as well as the accounting options available under current IAS 19 that the entity has selected. Regardless of the magnitude, employee compensation is a fundamental area of accounting and all entities need to be aware of these changes and carefully consider the potential implications.

The focus of this publication is to discuss the key accounting impact from EYs perspective as a result of the revised standard.

Background

Timeline



A key purpose of these revisions was to create greater consistency in accounting for employee benefits by eliminating the recognition and presentation options that exist under current IAS 19. Furthermore, the IASB sought to provide more targeted disclosure requirements that would highlight the relevant risks of defined benefit plans.

The IASB has also taken the opportunity to finalise proposals for termination benefits at the same time as those for other employee benefits. These proposals were originally included in the exposure draft, *Proposed Amendments to IAS 37 and IAS 19,* published in 2005. The revisions to accounting for termination benefits focus on assisting preparers in determining when a benefit is in exchange for future service as opposed to in exchange for termination of employment. The revisions also modify the recognition criteria for termination benefits.

Future steps

Whilst these revisions mark the conclusion of the IASB's limited scope improvements to IAS 19, the Board continues to acknowledge the need for a comprehensive review of the accounting for employee benefits.

In July 2011, the Board issued a Request for Views on the strategic direction and overall balance of their future agenda. A comprehensive review of the accounting for employee benefits is one potential topic being considered for the IASB agenda over the next three years. We strongly encourage preparers and users of IFRS financial statements to provide their views about the strategic direction and priority of projects for the future agenda of the IASB. The consultation period ends on 30 November 2011 and the Board intends to publish a feedback statement in Q2 2012.

Whether or not the IASB will add a comprehensive project on employment benefits will depend on the outcome of this public consultation process.

Defined benefit plans: significant changes

The accounting for post-employment benefits and, in particular, defined benefits plans was the area most significantly impacted by IAS 19R.

Immediate recognition of changes in pension related assets and liabilities

Under IAS 19, the following reporting options for the recognition of actuarial gains and losses were available:

- Immediate recognition through OCI
- Immediate recognition through profit or loss
- Deferred recognition through profit or loss (i.e., corridor approach)

IAS 19R eliminates these reporting options by requiring immediate recognition through OCI.

This is a significant change for those entities applying the corridor approach. Under this approach, entities could defer recognition of actuarial gains and losses if the net cumulative unrecognised value of actuarial gains and losses did not exceed the corridor (i.e., changes exceeding the greater of 10% of the defined benefit obligation and 10% of the fair value of plan assets).

The 'corridor approach' is often used amongst IFRS reporters as it allows for deferred recognition of actuarial gains and losses, thus leading to less volatility in the balance sheet. The revised standard eliminates this accounting option resulting in all changes in the valuation of post-employee benefits being recognised as they occur.

How we see it

These changes will result in increased balance sheet volatility for those entities currently applying the corridor approach. Entities should carefully consider how these changes will impact their key balance sheet metrics or debt covenants on a continuing basis.

The impact on the balance sheet at transition resulting from the corridor approach being removed will depend largely on the balance of the defined benefit obligation, the fair value of plan assets and, most importantly, the total of any unrecognised actuarial gains and losses. Below are some examples of how the impact could differ depending on these factors.

Example 1 — Removal of the corridor

		Scenarios		
(CU '000)		**1**	**2**	**3**
Fair value plan assets	A	7,000	2,100	5,000
Defined benefit obligation	B	6,800	2,300	5,600
Cumulative unrecognised actuarial gains (losses)	C	980	(330)	(480)
Net balance sheet defined benefit asset (liability):				
Current IAS 19	A-(B-C)	(780)	130	(120)
IAS 19R	A - B	200	(200)	(600)

Note: assumes no unrecognised past service costs on transition and ignores the impact of any asset ceiling limits.

It is important to note that entities currently recognising actuarial gains and losses immediately through profit or loss will also be significantly impacted as these amounts will now be recognised in OCI. Removing this option could result in an accounting mismatch in certain instances. For example, some insurance entities with self-insured pension plans maintain a portfolio of marked-to-market assets that do not qualify as plan assets under IAS 19 or IAS 19R. Actual returns on these assets held to settle the defined benefit obligation will be recognised in earnings, whilst actuarial gains and losses on the defined benefit obligation will be recognised in OCI.

There will be no subsequent recycling of amounts recognised in OCI into earnings under the revised standard.

How we see it

The fact that actuarial gains and losses are now recognised in OCI means they will permanently bypass profit or loss. This may result in IFRS users and analysts placing greater scrutiny or importance on amounts recognised in OCI, actuarial estimates and the disclosure of historical experience gains or losses.

Co-ordinating recognition for past service cost, amendments and curtailments

Current IAS 19 prescribes different treatment for plan amendments and curtailments, as follows:

- Curtailments are recognised when an entity is 'demonstrably committed' to a reduction in plan employees, or earlier, when the curtailment is linked to a wider restructuring
- Vested past service costs as a result of plan amendments are recognised when the amendments occur
- Unvested past service costs as a result of plan amendments are recognised on a straight-line basis over the remaining vesting period

IAS 19 deferred recognition for unvested past service costs is also applicable when the plan amendments result in a decrease in the benefits provided under the plan (i.e., negative past service costs).

In certain situations, a plan curtailment may be followed by a plan amendment, resulting in the need under IAS 19 to separate the impact of these transactions between the curtailment, unvested past service cost and vested past service costs. The revisions to IAS 19 reduce this complexity by redefining past service cost and co-ordinating the recognition timing as follows:

Excerpts from IAS 19R

102 Past service cost is the change in the present value of the defined benefit obligation resulting from a plan amendment or curtailment.

103 An entity shall recognise past service cost as an expense at the earlier of the following dates:

(a) when the plan amendment or curtailment occurs; and

(b) when the entity recognises related restructuring costs (see IAS 37) or termination benefits (see paragraph 165).

As a result, the accounting is converged and changes in the present value of the defined benefit obligation resulting from a plan amendment or curtailment will be recognised following a consistent basis.

The new recognition criteria are applicable to both vested and unvested past service costs. This means an entity can no longer defer recognition of unvested past service costs resulting from plan amendments over the remaining future vesting period. Instead, these costs will be recognised, along with the vested past service costs when the amendment/curtailment occurs (or earlier, if part of a wider restructuring).

How we see it

The different accounting treatments for plan amendments and curtailments under IAS 19 created complexity in both the accounting for changes in defined benefit plans, and in explaining the impact of these transactions to the financial statement users.

IAS 19R eliminates this complexity by aligning the accounting treatment for vested and unvested past service costs. However, this change will result in greater volatility in the balance sheet and profit or loss as there is no longer the ability to defer recognition of unvested past service costs.

Curtailments are also narrowly defined in IAS 19 as being related to future services. Any benefit reduction in relation to past service was considered a negative past service cost. There is no longer a need for this distinction as recognition of changes in the defined benefit obligation resulting from curtailments is aligned with recognition on plan amendments.

It is important to remember that the accounting for settlements has not changed and settlements will continue to be recognised when they occur. IAS 19R also does not resolve concerns about what is meant by 'occur' in relation to plan amendments or curtailments. 'Occur' could be interpreted as the date that plan amendments are agreed, communicated, executed or effective. However, in the Basis for Conclusion on IAS 19R, the Board indicated that the interpretation of 'occur' would depend on the facts and circumstances of each individual transaction and refers to the interaction with the definition of a constructive obligation.

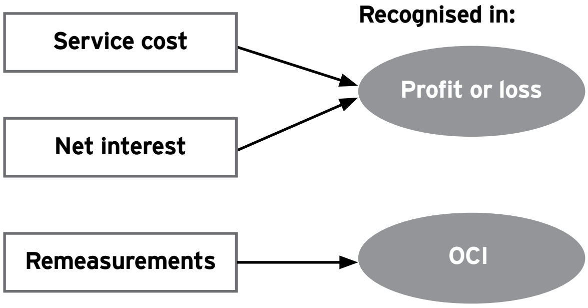
Excerpt from IAS 19R

61 An entity shall account not only for its legal obligation under the formal terms of a defined benefit plan, but also for any constructive obligation that arises from the entity's informal practices. Informal practices give rise to a constructive obligation where the entity has no realistic alternative but to pay employee benefits. An example of a constructive obligation is where a change in the entity's informal practices would cause unacceptable damage to its relationship with employees.

This means that plan amendments would be more likely to be considered to have 'occurred' at the date they are announced if unacceptable damage to an entity's relationship with employees would result if the entity does not fulfil its promise to amend its defined benefit plan. In making this assessment, entities should also consider whether the entity has commonly announced amendments and followed through on these in the past to be viewed as an 'informal practice'.

Recognising changes in defined benefit related assets and liabilities

The new requirements for accounting for changes in defined benefit related assets and liabilities are summarised in the following diagram.



Source: IASB webcast presentation, June 2011

Service costs

The revised standard defines service costs as including:

- Current service costs
- Past service costs
- Gains or losses on non-routine settlements

These concepts remain consistent with current IAS 19 with some clarifications.

The definition of past service costs has been modified to include not just those changes as a result of plan amendments, but also changes as a result of plan curtailments. Further details of these changes are discussed above under *Co-ordinating recognition for past service cost, amendments and curtailments*.

Net interest

Net interest expense (income) represents the change in the defined benefit obligation and the plan assets as a result of the passage of time. It is calculated as the product of the net balance sheet defined benefit liability (asset) and the discount rate used to measure the employee benefit obligation, each as at the beginning of the annual period.

Excerpt from IAS 19R

123 Net interest on the net defined benefit liability (asset) shall be determined by multiplying the net defined benefit liability (asset) by the discount rate specified in paragraph 83, both as determined at the start of the annual reporting period, taking account of any changes in the net defined benefit liability (asset) during the period as a result of contribution and benefit payments.

This change removes the concept of expected return on plan assets that were previously recognised in profit or loss. The impact on earnings will depend on the composition of plan assets, for example whether they are more debt or equity weighted. For some plans, the result could be earnings enhancing.

Example 2 — Net interest calculation

	(CU'000)
Assumptions at beginning of the annual period	
Fair value of plan assets expected return — 5.5%	1,350
Defined benefit obligation discount rate — 6.0%	1,020
Net defined benefit asset	330

The following amounts would be recognised in the annual statement of profit or loss. This excludes the impact of contributions and benefit payment in the period and the impact of the asset ceiling, if any.

Current IAS 19:	
Expected return [1,350 * 5.5%]	74
Defined benefit interest costs [1,020 * 6.0%]	61
Net	13
IAS 19R:	
Net interest income [330 * 6.0%]	20

In this simplified example, the plan assets are more cautiously invested resulting in a positive impact on profit or loss as a result of applying the net interest concept.

In practice, this change could have a material effect on profit and loss and earnings per share calculations for certain entities depending on the nature of their defined benefit plans.

Remeasurements

The following items represent remeasurements that are recognised in OCI under IAS 19R:

- Actuarial gains and losses
- Differences between the return on plan assets and interest income on plan assets (calculated as part of the net interest calculation discussed above)
- Changes in the asset ceiling (outside of any changes recorded as net interest)

As noted above, under *Immediate recognition of changes in pension related assets and liabilities* there will no longer be an option to recognise actuarial gains and losses in profit or loss. Furthermore, remeasurements will not be subsequently recycled through profit or loss. The June 2011 amendments to IAS 1 *Presentation of Financial Statements* will require separate presentation within OCI of those amounts that will be recycled to profit or loss from those that will not.

How we see it

The difference between actual returns and net interest income reported in earnings will permanently bypass earnings as an actuarial variance. This effectively removes the connection between the risk profile of plan assets and the amounts recorded in earnings. Care will be needed to explain performance to investors.

Presentation

IAS 19R does not specify where in the statement of profit or loss service costs or net interest should be presented. Instead, the presentation should follow the general requirements of IAS 1 and this presentation should be consistent with IAS 19 prior to the 2011 revisions (paragraph BC201 of the Basis for Conclusions on IAS 19).

Under IAS 19 and IAS 19R, there is no requirement to present current service cost, interest cost and expected return on plan assets as a combined single item on the face of the financial statements. Accordingly, entities may have applied different presentation requirements allowable under IAS 1, such as locating interest expense and expected return on assets as a component of finance costs. Entities should continue to present these costs in the financial statements consistent with current practice.

Clarifications for certain actuarial assumptions

IAS 19R clarifies in specific areas what should be considered an actuarial assumption that would be used to measure the present value of the defined benefit obligation. In many instances, these clarifications will not represent a change in accounting, but will confirm existing practice.

Administration costs

Current IAS 19 does not specify which administration costs to include as part of the return on plan assets. IAS 19R clarifies that administration costs directly related to the management of plan assets and certain taxes discussed below are required to be recognised as a reduction in the return on plan assets. As a result, these costs will be recorded as remeasurements through OCI.

Lump sum payments

The Board has clarified the definition of settlements to exclude settlements available under the existing defined benefit plan. These are often referred to as 'routine settlements' and are considered an actuarial assumption that should be included in the initial and subsequent measurement of the defined benefit obligation.

The most obvious example of a routine settlement is the option to take a lump sum payment instead of an annuity. Initial measurement of the defined benefit obligation would include an estimate of the likelihood the employees would opt for an up-front lump sum payment in lieu of continuing annual benefits upon retirement. Any changes in this estimate or differences between the expected lump sum payments and actual experience would be recognised as actuarial gains or losses through OCI.

This is applicable even if the entity's initial assumption is that no employees will take the lump sum payment option (i.e., changes in the defined benefit obligation resulting from unanticipated lump sum payments would still be reflected in OCI).

This treatment is consistent with the IFRS Interpretations Committee's rejection notice in May 2008 on this topic and is not expected to be a change from current practice.

Taxes

IAS 19R clarifies that the present value of the defined benefit obligation would include taxes payable by a plan on contributions relating to services costs provided by the employee before the end of the reporting period. An example of this would be any taxes payable by the plan when an employer makes contributions to the plan.

All remaining taxes payable by the plan are considered a reduction in the return on plan assets and would be recognised as a reduction in OCI. This would include, for example, investment income taxes payable by the plan.

Expected mortality rates

It has been explicitly stated in the revised standard that mortality rates will reflect current estimates of the expected employee mortality rates. This specifically includes modifying standard mortality tables to reflect estimates of mortality improvement anticipated to occur after the reporting date (IAS19R.82).

Risk sharing

A defined benefit plan may include features that seek to share risks or limit the employer's risk in some way. IAS 19 provided limited guidance on risk sharing arrangements resulting in this being one of the key areas the IASB believes there is diversity in practice. The revisions to IAS 19 seek to address this divergence.

Excerpts from the Basis for Conclusions on IAS 19R

BC143 The amendments made in 2011 clarify that:

(a) the effect of employee and third-party contributions should be considered in determining the defined benefit cost, the present value of the defined benefit obligation and the measurement of any reimbursement rights.

(b) the benefit to be attributed to periods of service in accordance with paragraph 70 of IAS 19 is net of the effect of any employee contributions in respect of service.

(c) any conditional indexation should be reflected in the measurement of the defined benefit obligation, whether the indexation or changes in benefits are automatic or are subject to a decision by the employer, the employee or a third party, such as trustees or administrators of the plan.

(d) if any limits exist on the legal and constructive obligation to pay additional contributions, the present value of the defined benefit obligation should reflect those limits.

These revisions are aimed at addressing the following two common types of risk sharing arrangements:

- Sharing of the benefits of a surplus (i.e., upside risk) and the cost of a deficit (i.e., downside risk) between the employer and the employee or other third party (e.g., government)
- Level of plan benefits that are conditional on there being sufficient assets in the plan

The changes discussed in BC143(a) — (b) above deal with the first type of risk sharing arrangements. Changes in the employee or third-party contributions are recognised under the revised standard as part of service costs in earnings and remeasurements through OCI. Accordingly, the estimated outcome of the risk sharing arrangement would be incorporated in the valuation of the defined benefit obligation.

IAS 19R also makes it clear that discretionary third party contributions should not be accounted for until the contributions occur. In other words, service costs recognised in profit or loss will be reduced by discretionary third party contributions in the period those contributions are made.

The last two revisions discussed in BC143(c) — (d) above deal with optionality or restrictions on the entity's defined benefit obligation. Entities are required to consider the impact these options would have on the present value of the defined benefit obligation. As part of this assessment, entities should use current assumptions about future events. Subsequent changes in those assumptions would be considered as part of the actuarial gains or losses recorded in OCI.

Example 3 — Conditional indexation

An entity has a defined benefit plan that includes a minimum funding amount. In addition, the entity will pay its employees an additional 5% annual annuity in periods where the plan assets achieve a rolling 5-year average return greater than 8% per annum.

Under IAS 19R, the entity would need to estimate the related cash outflows resulting from this optional benefit and incorporate these estimates into the present value of the defined benefit obligation. Making this estimate would involve a number of judgements, including projecting expected future returns on plan assets over the life of the defined benefit plan to identify which periods would have an increase in projected cash outflow. This projection must be based on current assumptions.

Defined benefit plans: interim reporting considerations

IAS 19R does not include additional guidance for interim reporting or propose changes to interim reporting under IAS 34 *Interim Financial Reporting*. However, the revisions do bring to light certain issues for entities to consider when preparing interim accounts. This includes differences between the requirements for remeasurement of the balance sheet amounts and recognition through profit or loss.

Remeasurement of the net defined benefit liability (asset)

The first issue is determining if there is a need to remeasure the net defined benefit liability (asset) at the end of the interim reporting period. Under IAS 34, entities are required to apply the same recognition and measurement approach in its interim financial statements as are applied in its annual financial statements. IAS 19R and IAS 34 require the following:

Excerpt from IAS 19R

58 An entity shall determine the net defined benefit liability (asset) with sufficient regularity that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the end of the reporting period.

Excerpt from Illustrative Examples for IAS 34 (amended by IFRS 13 *Fair Value Measurement* in May 2011)

C4 **Pensions**: IAS 19 *Employee Benefits* requires that an entity determine the present value of defined benefit obligations and the fair value of plan assets at the end of each reporting period and encourages an entity to involve a professionally qualified actuary in measurement of the obligations. For interim reporting purposes, reliable measurement is often obtainable by extrapolation of the latest actuarial valuation.

This requirement has not changed and is the same as current IFRS. However, entities that apply the corridor approach could see a significant change. Under IAS 19, these entities would have only recognised actuarial gains or losses if the net cumulative unrecognised value of actuarial gains or losses exceeded the corridor. This ability to defer actuarial gains and losses decreased the likelihood of material fluctuations in the balance sheet amount of the net defined benefit liability (asset) at the end of the interim reporting period.

In addition, the new requirements to recognise unvested past service costs when plan amendments occur, may also increase the likelihood for material fluctuations in the balance sheet amounts in those interim periods where plan amendments occur for all entities with defined benefit plans.

Interim amounts recognised through profit or loss

The requirements of IAS 34 relating to pension costs recognised in profit or loss have not changed and will continue to be calculated on a year-to-date basis using the actuarially determined pension cost rate at the end of the prior year, adjusted for significant market fluctuations, curtailments, settlements, or other one-time events. Accordingly, considerations for determining what is a significant change will still be required under IAS 19R.

However, a possible area of change could be in the recognition of net interest expense (income) that was introduced by the revised standard. There was mixed practice amongst IFRS preparers for computing expected returns on plan assets and interest costs on the defined benefit obligation. Some use the interim period revaluations of the pension assets and defined benefit obligation, whilst others use the annual opening balances for calculating these amounts.

The Boards recognised that a key tenet of interim reporting is that the frequency of interim reporting should not impact the amounts reported in annual financial statements. To address concerns that the interim remeasurements could result in a different calculation of net interest, the IASB added that net interest expense (income) should be calculated using the net defined benefit liability (asset) at the start of the annual period. Contributions and benefit payments made during the annual period would be taken into account in the calculation, but no other changes should be considered. This means that returns on plan assets or actuarial gains or losses during the year should not be considered in the net interest expense (income) calculation.

Defined benefit plans: modified disclosures

There are a number of concerns surrounding disclosures for defined benefit plans and the revised standard is aimed at resolving the following criticisms of current IAS 19:

- Insufficient information to allow users to understand the financial statement effects of defined benefit liabilities and assets as a whole
- Large volume of disclosures that do not clearly articulate the underlying risks of the defined benefit plans

IAS 19R includes both new disclosure requirements and changes to existing requirements.

Creating disclosure objectives

The revised standard provides objectives for defined benefit plans, as follows:

Excerpts from IAS 19R

135 An entity shall disclose information that:

(a) explains the characteristics of its defined benefit plans and risks associated with them (see paragraph 139);

(b) identifies and explains the amounts in its financial statements arising from its defined benefit plans (see paragraphs 140-144); and

(c) describes how its defined benefit plans may affect the amount, timing and uncertainty of the entity's future cash flows (see paragraphs 145-147).

By clearly articulating the principles behind the defined benefit disclosures, this will provide entities with a framework for which to identify the overall tone and extent of disclosures that are made.

Furthermore, these objectives are underpinned by some key considerations that entities should keep in mind when preparing the financial statement notes. These are:

- Level of required detail
- Emphasis on the various requirements
- Aggregation/disaggregation of disclosures
- Potential for additional information

These considerations were meant to assist IFRS preparers in reconciling the broad principles noted above with the fact that extensive lists of required disclosures still remain in the standard. In the Basis for Conclusions on IAS 19R the IASB reiterated that information that is immaterial is not required to be disclosed as set out in paragraphs 31 of IAS 1.

Excerpts from the Basis for Conclusions on IAS 19R

BC207 The Board sought an approach that:

(a) provides sufficient disclosures about defined benefit plans when those plans are material to the entity's operations.

(b) provides users of financial statements with relevant information that is not obscured by excessive detail.

Effectively, the IASB is encouraging IFRS preparers to consider materiality and the above key considerations when preparing defined benefit plan disclosures.

In addition, the revisions recognise that additional disclosures may be required to meet these broad disclosure objectives, regardless of whether they are included in the list of mandatory disclosures.

How we see it

The addition of clear disclosure objectives provides IFRS preparers with an opportunity to take a fresh look at their defined benefit plan disclosures.

Eliminating immaterial disclosures will enhance the financial statement user's ability to focus on those transactions and details that truly matter.

Disclosures of defined benefit plan characteristics

The required characteristics of defined benefit plan disclosures remain largely unchanged with some minor adjustments that are set out below.

Exposure to risks

A narrative description of an entity's risk exposure arising from involvement with the defined benefit plan is now required. This should focus on unusual risk, entity-specific (or plan-specific) risk and significant concentrations of risk.

Example 5 – Plan-specific risk exposure

A plan that has invested 70% of plan assets in oil and gas sector securities might consider this to be a significant area of risk. The same would be the case for other significant concentration of the plan assets invested in one market area (e.g., property, country-specific assets).

Determining whether there is a significant exposure to risk would also require materiality considerations as set out in IAS 1.

Separating demographic and financial assumptions

Entities will now be required under IAS 19R to segregate and disclose the impact of actuarial gains or losses resulting from changes in demographic assumptions from those relating to financial assumptions.

Demographic assumptions are defined in paragraph 76(a) of IAS 19R as those that deal with future characteristics of employees. These would include estimates of future mortality rates, staff turnover, early retirement and the proportion of plan members who will select lump sum payments instead of annuities. Conversely, financial assumptions would encompass items such as discount rates and benefit levels (inclusive of future salary estimates).

This means entities will now be required to separate the impact from different assumptions when measuring the defined benefit obligation. This might require advance discussion with an entity's actuary to ensure that the actuarial report(s) provide sufficient details to meet this new disclosure requirement.

Changes in defined benefit plans

The disclosure requirements for plan amendments, curtailments and settlement remain largely unchanged from IAS 19.

However, the revised standard does not require an entity to distinguish between past service costs resulting from a plan amendment, past service cost resulting from a curtailment and a gain or loss on settlement when these transactions occur together. This is also in line with the fact that IAS 19R provides aligned accounting recognition criteria for plan amendments and curtailments as discussed above under *Co-ordinating recognition for past service cost, amendments and curtailments*.

Accordingly, an entity will not be required to re-measure the defined benefit obligation multiple times to segregate the impact of these transactions when they occur at the same time. The result is reduced complexity for preparers.

Disaggregation of plan assets

IAS 19R removes the current list of minimum categories into which plan assets need to be disaggregated (i.e., equity instruments, debt instruments, property, and all other assets). Instead, preparers are now provided with the following principle:

Excerpt from IAS 19R

142 An entity shall disaggregate the fair value of the plan assets into classes that distinguish the nature and risks of those assets, subdividing each class of plan asset into those that have a quoted market price in an active market (IAS 39 *Financial Instruments: Recognition and Measurement* paragraph AG71) and those that do not ...

This could result in less uniform disclosure categories between IFRS reporters. However, the categories disclosed should be more meaningful to financial statements users as they are no longer based on an arbitrary listing. Instead the disclosures would be based on individual facts and circumstance applicable to the entity. In addition, entities are now required to sub-divide the disclosed classes of plan asset between those that have a quoted market price in an active market and those that do not. This will align the plan asset disclosures closely with certain financial instruments disclosures. The purpose is to provide financial statement users with information on the reliability of plan asset measurements.

How we see it

The new plan asset disaggregation disclosures allow for a principle based approach to disclosing categories of plan assets. This should result in a more meaningful break-down of plan assets in the financial statement notes.

The requirements to subdivide categories of plan assets between those that are based on quoted market prices in an active market and those that are not could be difficult to assess and apply. This is particularly relevant in instances where a third party is used to manage the plan assets. In these cases, early communication with the plan administrators to understand the valuation approaches used for plan assets is imperative.

Amount, timing and uncertainty of future cash flows

The more significant new disclosure requirements introduced by the revisions relate to disclosing sensitivity of the defined benefit obligation to actuarial assumptions, future funding requirements and asset-liability matching strategies.

Under IAS 19R, an entity is required to show the impact on the defined benefit obligation of a reasonably possible change for each significant actuarial assumption as at the end of the reporting period. This represents further application of the general requirements in IAS 1 relating to estimation uncertainty and attempts to provide financial statement users with information on the potential impact of measurement uncertainty.

The first step in providing sensitivity disclosures would be to identify those actuarial assumptions that are considered significant in calculating the present value of the defined benefit obligation. These assumptions would then need to be disclosed under paragraph 144 of the revised standard. In contrast, IAS 19 requires disclosure of the discount rate, expected return on plan asset, expected rates of salary increases, medical cost trend rates, as well as any other material actuarial assumptions used.

It is unclear whether there will really be a difference in practice of disclosing actuarial assumptions to change from 'material' actuarial assumption to 'significant' actuarial assumption. However, the move from a mandatory list could result in less disclosure for insignificant assumptions that are currently required under IAS 19.

Example 6 — Determining significant actuarial assumptions
An entity whose plan contains a large number of members that are already retired or very close to retirement is less impacted by expected salary increases than one where the average age to retirement is higher.

For these plans with members close to retirement, it might be reasonable that expected salary increases are not a significant actuarial assumption when considered in tandem with other factors (e.g., overall size and materiality of the defined benefit plan to the entity's operations as a whole).

Once the significant actuarial assumptions are identified, the second step is then to determine what would be considered a reasonably possible change in these assumptions. The IASB has not provided any guidelines or boundaries for making this determination (such as a band of percentage changes). Instead, an entity would be required to make its own assessment based on the current environmental factors at the end of the reporting period. For example, if the market for high-quality corporate bonds is showing a great deal of volatility (i.e., as a result of recessionary pressures), then the estimate of a 'reasonably possible change' is likely to be higher than in a period that forecasts economic stability. This is an area where significant judgement will need to be applied and that judgement will need to be reconsidered at each reporting date for possible changes in circumstances.

Consistent with the sensitivity disclosure requirements in IFRS 7 *Financial Instruments: Disclosures*, entities will also be required to disclose:

- The methods and assumptions used in preparing the sensitivity disclosures, including any limitations of those methods
- Any changes from the previous period in the methods and assumptions used, including the reasons for any changes

How we see it

There is no 'one size fits all' approach to determining a reasonably possible change in actuarial assumptions or identifying which assumptions are considered significant. As a result, entities will need to co-ordinate closely with actuaries to ensure the required sensitivity information is available on a timely basis.

It is important to remember that, although IFRS 13 *Fair Value Measurement* is applicable to the measurement of plan assets, the fair value disclosures set out in IFRS 13 are not required for plan assets.

IAS 19R also proposes a number of new disclosure requirements aimed at providing financial statement users with sufficient information of the future cash outflows for defined benefit plans, along with the related risk to those cash flows. These include:

- A description of funding arrangements, including the funding policy of the defined benefit plan
- Expected contributions for the next annual reporting period
- Information about the maturity profile of the defined benefit obligation (including, but not limited to, weighted average duration of the defined benefit obligation)

In addition to the above cash flow information, management will also be required to disclose details of any asset-liability matching strategies applicable to the defined benefit plans.

Multi-employer and group plan changes

IAS 19R leaves the requirements for multi-employer and group plans largely unchanged. However, some additional disclosure requirements were added to provide users with enhanced information about the risks and uncertainties particularly relevant for these types of plans. These include the following additional disclosures for multi-employer plans:

- Qualitative information about any agreed deficit or surplus allocation on wind-up of the plan, or the amount that is required to be paid on withdrawal of the entity from the plan
- Expected contributions for the next annual period
- Level of participation in a multi-employer plan

The additional disclosure regarding the withdrawal and wind-up obligations are meant to solidify the interrelationship with contingent liability disclosure in IAS 37. The revisions to IAS 19 also make it explicit that a withdrawal liability would be recognised and measured under IAS 37 (paragraph 39 of IAS 19R). These liabilities would generally be recognised when it becomes probable that the entity will withdraw from the plan.

Clarifications on termination benefits

Termination benefits are considered to be fundamentally different from benefits for employee services as the activity or action that gives rise to the entity's liability is the termination itself. Therefore, they are unrelated to employee services. The 2011 revisions include changes in the recognition of termination benefits, along with a clarified definition of termination benefits.

Modified timing of recognition

IAS19R requires termination benefits to be recognised at the earlier of:

- When the offer cannot be withdrawn
- When the related restructuring costs are recognised under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

For termination benefits outside of a wider restructuring it will no longer be sufficient for an entity to be only demonstrably committed to providing termination benefits, which is the current IAS 19 requirement. Implicit in the new recognition criteria is that there needs to be an offer of termination that binds the entity in some way. This is the action or activity deemed to give rise to the termination liability.

How we see it

Termination costs that are part of a wider restructuring will now be recognised at the same time as the other restructuring costs under IAS 37. This treatment has intuitive appeal as it provides a more comprehensive view of restructuring activities.

For other terminations, the related costs will now likely be recognised later or remain unchanged from current IFRS.

The revised standard identifies two broad categories of termination benefits:

1) Benefits resulting from the employee's decision to accept the offer of termination

2) Benefits resulting from the entity's decision to terminate an employee's employment

The first category would be recognised under the revised standard at the earlier of when the employee accepts the offer, when the entity is unable to withdraw an offer that was made or when the related restructuring costs are recognised. This inability to withdraw an offer could be as a result of many things, including legal, regulatory or contractual requirements. If the local labour laws do not allow an entity to withdraw an offer of termination once made (i.e., it is a legally binding offer), then the recognition criteria would be met.

The second category would be recognised at the earlier of when the related restructuring costs are recognised or when the entity has communicated a plan for termination to the affected employees and all the following criteria are met:

(a) It is unlikely that significant changes to the plan will be made

(b) The number of employees whose employment is to be terminated, their job classifications or functions and their locations and the expected completion date has been identified

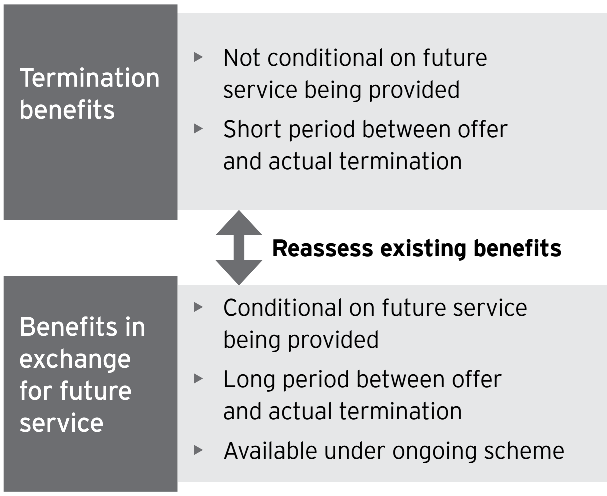
(c) The termination benefits that employees will receive are established in sufficient detail that employees can determine the type and amount of benefits they will receive when their employment is terminated

This criteria is set out in paragraph 167 of IAS 19R. Although some of the requirements are similar to IAS 19, such as item (b) in the list above, there remain fundamental differences. This reinforces common practice that recognition of termination benefits that are part of a wider restructuring require the plan to be communicated to employees.

Termination benefits defined

The IASB has provided further clarity on what constitutes benefits in exchange for future service. Termination benefits are a direct result of termination of employment and are therefore unrelated to future employee service.

Following are the fundamental principles to be used in distinguishing between termination benefits and ongoing employment benefits:



In many cases, these clarifications should solidify existing practice and are unlikely to result in significant changes to current IAS 19 classification.

However, entities should still evaluate their related benefit arrangements on transition to ensure these principles are correctly applied.

Further measurement criteria

Example 7 — Termination benefits or benefits for future service
An entity announces its decision to close its factory located in Country A and terminate all 200 employees as a result of the economic downturn.

The entity will pay a CU 20,000 per employee benefit upon termination. However, to ensure the wind-up of the factory occurs smoothly and all remaining customer orders are completed, the entity needs to retain at least 20% of employees until closure of the factory in eight months.

As a result, the entity announced in a corporate memo to all employees that employees that agree to stay until the closing of the factory will receive a CU 60,000 payment at the end of the eight months (in addition to receiving their current wage throughout that period of service) instead of the CU 20,000. Based on this offer and the current market conditions, the entity expects to retain 50 employees until the date the factory is closed.

Accordingly, the entity expects to pay a total benefit to employees of CU 6,000,000 (CU 60,000 * 50 employees that will stay + CU 20,000 * 150 remaining employees) for closing the factory.

Of this benefit, CU 4,000,000 (200 * CU 20,000) would be considered related to termination of employment. This conclusion is based on the fact that this would be the cost to the entity of its decision to close the factory regardless of whether the employees are terminated today or eight months later. Assuming the widespread announcement does not allow for the entity to withdraw the offer, these costs would be recognised at the earlier of the date of announcement or when any related restructuring costs are recognised under IAS 37.

The additional payment of CU 40,000 (60,000 offered – 20,000 required) is contingent on the employees providing future service and is therefore considered a benefit in exchange for future services. This is in essence the cost the entity is willing to pay to convince employees to stay for the additional eight months. Accordingly, the remaining benefit of CU 2,000,000 (40,000 * 50) would be recognised over the related service period at CU 250,000 a month (2,000,000 / 8 months). This accrual would be adjusted for changes in estimates at the end of each reporting period (e.g., changes in the estimated number of employees expected to stay until the factory is closed).

The revised standard clarifies the measurement criteria for termination benefits would mirror employment benefits as follows:

- Termination benefits expected to be settled in the short-term will be measured like short-term employee benefits
- Termination benefits expected to be settled in the long-term will be measured like long-term employee benefits
- Termination benefits that are enhancements to post-employment benefits will be measured like post-employment benefits

As termination benefits are not related to future service costs, there will be no allocating of costs to the service periods.

New definition of short-term employee benefits

The short-term employee benefits category exists as a practical accounting expedient that allows preparers to use a simplified measurement approach. This simplified approach is not meant to be materially different from the underlying measurement principles of IAS 19. Generally, short-term employee benefits would typically include costs such as bonuses, wages, salaries and paid annual leave.

IAS 19 defined short term employee benefits as those benefits due to be settled (i.e., paid) within 12 months of the end of the reporting period. IAS 19R provides the following definition:

Excerpts from IAS 19R

5(a) *Short term employee benefits* are employee benefits (other than termination benefits) that are expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related services.

As a result, the distinction between short-term and other long-term employee benefits will now be based on expected timing of settlement rather than the employee's entitlement to the benefits. The move to using expected timing requires management to make its best estimates of future cash flows and will require predicting future behaviour of employees and events. For example, predicting the expected usage of accumulating annual leave.

How we see it

Although this may seem like a minor wording change, using the expected timing of settlement introduces a greater element of judgement in classifying employee benefits.

There is the potential for certain benefits classified as short-term to now be classified as other long-term resulting in measurement differences. Entities should make an assessment of their existing benefits to determine the appropriate classification under this new definition.

The first step in applying the expected timing concept requires IFRS preparers to consider what level to apply the new definition at. The result could be different if the assumptions were considered at the individual employee level, group(s) of employees level (such as a business unit) or at the category of benefits as a whole level. This is commonly referred to as determining the unit-of-account.

To assist users in making the unit-of-account decision, the IASB provided the following:

Excerpts from the Basis for Conclusions on IAS 19R

BC20(a) the Board concluded that the classification of the benefits should reflect the characteristics of the benefits, rather than the demographic or financial assumptions at a point in time.

BC20(b) the Board concluded that an entity should classify a benefit as a short-term employee benefit if the whole of the benefit is expected to be settled before twelve months after the end of the annual reporting period in which the related service was provided. This will ensure that the benefit is measured on the same basis throughout its life and is consistent with the measurement requirements of paragraph 69.

This indicates that benefits available to all employees should be viewed as one category of benefit if those benefits have uniform characteristics, such as being accumulating or non-accumulating in nature. As a result, the unit-of-account is at the benefit level. This is further clarified in BC21(a) where the Board rejected proposals to account at an individual employee level as this would not meet the objectives of classification.

The use of the words 'whole of the benefit' in BC20(b) above also indicates it would be inappropriate to separate benefits with uniform characteristics into short-term and long-term portions. If a portion of these uniform benefit is expected to be settled outside the twelve months after the end of the annual reporting period, then the whole of the benefits will be considered other long-term employee benefits.

Another complication of using the expected settlement date is how to deal with subsequent changes in those expectations. The Basis for Conclusions on IAS 19R indicate that the classification of a short-term benefit plan needs to be revisited if it no longer meets the definition (i.e., it is no longer expected to be settled wholly within twelve months of the end of the annual reporting period). However, a temporary change in expectation would not necessarily trigger a reclassification as there is no change in the underlying characteristics of the employee benefits themselves.

With the new definition, it is possible that fewer benefits will be classified as short-term employee benefits. The main measurement differences between short-term and other long-term employee benefits involve the concept of projecting future cash outflows and discounting back to a present value of the liability. There would also be an element of actuarial estimates that could impact the calculation (for example, where benefits are forfeited in the event of termination of employment).

Example 8 — Accumulating annual leave

An entity provides 30 days of accumulating annual leave to all of its employees. The annual leave will continue to rollover for a period of 3 years if not taken in the first year. However, leave rolled-over to subsequent periods is not paid out in the event of employment termination at the request of the employee.

At the end of the entity's annual reporting period (31 December 2011), the entity notes the following:

- 2,000 employees have 16 days of 2011 annual leave on average per employee remaining
- Based on historical trend, 50% (8 days) of the outstanding leave is expected to be taken in the next twelve months and 25% (4 days) in each of the subsequent two years
- Employees' average salary is CU70,000, with 10% increases expected per annum
- Turnover is expected to be 20% per annum
- Discount rate is 5% (determined as the high quality corporate bond rate in accordance with paragraph 83 of IAS 19R)
- Average of 260 working days per annum

In this example, the fact that the outstanding annual leave is not expected to be settled wholly within 12 months of the end of the annual reporting period results in these benefits being classified as other long-term employee benefits. The related accrued benefits obligation would be calculated as follows:

	2012	2013	2014
Number of employees (with 20% turnover)	2,000	1,600	1,280
Rollover days taken	8	4	4
Expected salary (with 10% increases)	77,000	84,700	93,170
Expected cash flow	4,738,462	2,084,923	1,834,732
Discounted at 5%	4,512,821	1,891,087	1,584,911
Benefit obligation at 31 December 2011:			7,988,818

In many cases, we would not expect the change in classification from short-term employee benefits to other-long term employee benefits to be material. However, in some circumstances, the element of discounting combined with the effect of future salary increases could be significant, such as for material accumulating benefits that are not expected to be settled until far into the future. The ultimate impact on an entity will depend on the magnitude of the benefits, future cash flow assumptions and the projected timing for settlement.

It is important to note that the magnitude of this change was significantly impacted by the IASB's decision to revise its original ED proposals on accounting for other long-term employee benefits. Originally, the ED proposed changes in estimates (e.g., discount rate, cash flow timing, future salary increases) for other long-term employee benefits to have the same accounting as post-employment benefits (i.e., recognition of changes in estimates through OCI). However, this is not the case and IAS 19R requires all changes in assumptions related to other long-term employee benefits to be recognised in profit or loss.

Transition

The standard is required to be applied retrospectively for annual periods starting 1 January 2013. However, there are two exceptions to full retrospective application within the standard:

- Assets outside the scope of IAS 19 that include employee benefit costs in their carrying amount do not need to be adjusted for periods before the beginning of the financial year in which IAS 19R is first applied. Examples of assets that potentially include the cost of employee benefits are inventory, fixed assets and development costs. As a result, previously unrecognised actuarial gains and losses and unrecognised past service costs will not need to be allocated to the carrying amount of assets and instead can be adjusted directly to the opening equity balance.
- Entities are not required to provide comparative defined benefit sensitivity disclosures for annual periods beginning before 1 January 2014. This means that, in the year of adoption, entities will not be required to present comparative sensitivity analysis.

IFRS reporters need to remember that the retrospective application does not just impact consolidated defined benefit plan accounting, but also impacts other areas. For example, entities will be required to restate the impact of disposals of subsidiaries and acquisitions of non-controlling interests for transactions that occurred during the comparative period. This is because the gain or loss on disposal or impact on equity of these transactions will need to be recomputed on the basis of the subsidiary's net equity including full recognition of actuarial gains and losses. Also, entities should not forget to account for the impact on equity accounted investments that have defined benefit plan assets and liabilities.

How we see it

- Changes in the accounting for defined benefit plans will have a significant impact on financial reporting. Entities need to consider if there are any impacts to key performance measures and potentially on debt covenants. Early analysis and communication with creditors and investors will be key to a smooth transition.
- The increased disclosures and changes in accounting for defined benefit plans will also require early communications with actuaries or those performing the defined benefit obligation valuations.
- Some of the seemingly minor adjustments, such as the changes in definition for short-term employee benefits and changes in recognition for termination benefits may require further analysis of existing arrangements.

Appendix – Main differences or clarifications at a glance

Following table summarises the main accounting changes set out in IAS19R and the potential implications this may have.

What has changed?	How has IAS 19 changed or been clarified?	What does this mean for you?
Post-employment benefits – *recognition and presentation of actuarial gains and losses*	▸ Under current IAS 19, actuarial gains and losses could have been recognised in OCI, profit or loss or deferred (under certain criteria) depending on the entity's accounting policy choice. ▸ IAS 19R removes these options and instead requires actuarial gains and losses to be recognised in OCI as they occur.	▸ Entities that apply the corridor approach will have increased balance sheet volatility which may impact key balance sheet metrics or debt covenants on a continuing basis. ▸ The removal of options will result in more consistency amongst IFRS users on when and where changes in post-employment assets and liabilities are recognised.
Post-employment benefits – *recognition in changes in the net defined benefit liability (asset)*	▸ Under current IAS 19, an entity would recognise service costs, expected returns on plan assets, and interest expense on the defined benefits obligation (resulting from the passage of time) in profit or loss. ▸ IAS 19R limits the amounts recorded in profit or loss to service cost and net interest expense (income). Net interest expense (income) is the product of the net balance sheet pension liability or asset and the discount rate used to measure the employee benefit obligation. ▸ Remeasurements, representing actuarial gains and losses, returns on plan assets (outside of any changes recorded as net interest) and any changes in the asset ceiling (outside of any changes recorded as net interest), are recognised in OCI. ▸ Remeasurements will not be recycled from OCI into profit or loss.	▸ The difference between returns on plan assets and net interest income will not be recognised in profit or loss. This effectively removes the link between profit or loss and the risk profile of plan assets. ▸ The financial statement impact of this change will depend on the level of funding of the plan and the composition of plan assets (e.g., more debt or equity weighted). In cases where the expected return was greater than the discount rate used for the employee benefits obligation, this change will result in a decrease in profit or loss. ▸ The June 2011 amendments to IAS 1 require separate presentation within OCI of those amounts that will be recycled to profit or loss from those that will not. The latter includes remeasurements of post-employment benefits.
Post-employment benefits – *recognition of past service costs*	▸ Accounting for changes in the defined benefit obligation resulting from plan amendments and curtailments has been aligned. ▸ Past service costs are now recognised at the earlier of the date of amendment/curtailment of the defined benefit plan or when the entity recognises related restructuring costs or termination benefits. ▸ As a result, unvested past services can no longer be deferred over the future vesting period.	▸ Aligning the accounting treatment for plan amendments and curtailments will reduce complexity in accounting for changes in defined benefit plans. ▸ Entities will see increased balance sheet and income statement volatility in periods where unvested past service costs arise as a result of plan amendments or curtailments.

What has changed?	How has IAS 19 changed or been clarified?	What does this mean for you?
Post-employment benefits – *measurement*	▸ IAS 19R provides clarification in a number of areas on what assumptions should be included in measuring the defined benefit obligation. These areas include lump sum payments, taxes payable by the defined benefit plan, mortality assumptions, administration costs of the plan and risk sharing arrangements (with employees or other third parties).	▸ The revisions to risk sharing arrangements are aimed at reducing diversity in practice. The other clarifications for actuarial assumptions are likely to confirm existing practice in many instances.
Post-employment benefits – *disclosures*	▸ Objectives for defined benefit plan disclosures are set out in IAS 19R that provide key considerations in determining the extent of required disclosures. ▸ There are a number of new and modified requirements for defined benefit plan disclosures. The most significant include the requirement to disclose quantitative sensitivity of the defined benefit obligation to reasonably possible changes in significant actuarial assumptions.	▸ The addition of disclosure objectives provides IFRS preparers with an opportunity to take a fresh look at their defined benefit plan disclosures and to eliminate immaterial disclosures that bring no value to the reader of the financial statements. ▸ Entities will need to apply judgement in determining which actuarial assumptions are considered significant and what is viewed as a reasonably possible change in those assumptions for providing sensitivity disclosures. ▸ The new disclosures require additional data to be gathered. Entities need to communicate early with their actuary or those who perform the defined benefit obligation calculations to ensure this information is readily available.
Termination benefits – *definition*	▸ Termination benefits are amounts paid to employees in exchange for termination of employment. They exclude any amounts paid in exchange for future service. ▸ IAS 19R provides an illustrative example to assist in distinguishing between these two types of benefits.	▸ By enhancing the definition, it is clearer what is considered a termination benefit and what constitutes benefits in exchange for future service. However, in many cases, these clarifications are likely to reinforce current practice.

What has changed?	How has IAS 19 changed or been clarified?	What does this mean for you?
Termination benefits – *recognition timing*	▸ Termination benefits (outside of a wider restructuring) are recognised only when the offer cannot be withdrawn. This includes the requirement for an entity to communicate the plan of termination to employees before recognising a constructive obligation. ▸ In the context of a wider restructuring, termination benefits are recognised at the same time as the other restructuring costs under IAS 37 *Liabilities*.	▸ Recognising the termination costs of a restructuring at the same time as the other related costs involved with a restructuring will allow entities to present a more complete picture of the impact of restructuring plans. ▸ For terminations outside of a wider restructuring, termination costs will now likely be recognised later.
Termination benefits – *measurement criteria*	▸ IAS 19R provides measurement criteria for termination benefits that mirror employment benefits based on the nature of the termination benefits.	▸ Many entities may already be applying measurement criteria to termination benefits that mirror the measurement of employee benefits. The revisions now make it clear that this is a requirement.
Short-term employee benefits – *definition*	▸ The distinction between long-term and short-term employee benefits is now based on the expected timing of settlement, as opposed to when the employees are entitled to the benefits.	▸ Some employee benefit plans currently classified as short-term may be reclassified as other long-term employee benefits under IAS19R. ▸ Short-term employee benefits reclassified as other long-term employee benefits under IAS 19R will now be measured by projecting and discounting expected future cash outflows.

Transition	▸ Retrospective application with limited exceptions	▸ Restatement of comparatives, in particular:
		  ▸ Opening equity at the start of the earliest period presented
		  ▸ Restatement of comparative statement(s) of comprehensive income both for direct consequences (e.g., recognition of actuarial gains and losses, past service costs and interest income/expense) and indirect consequences (e.g., computation of gains and losses on disposals of subsidiaries).

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