pwc.com/ifrs

Practical guide to IFRS

IAS 19 amendment to significantly affect the reporting of employee benefits

August 2011

At a glance

- The IASB has amended its standard on accounting for employee benefits. The biggest impact of the changes is on defined benefit plans and other post-employment benefits; however, termination benefits and other employee benefits are also affected.

- Actuarial gains and losses, the effect of the asset ceiling and the actual return on plan assets ('remeasurements') are recognised in the balance sheet immediately, with a charge or credit to other comprehensive income (OCI) in the periods in which they occur. They are not recycled.

- There will be less flexibility in income statement presentation. Defined benefit cost will be split into two categories: (1) service cost, past-service cost and settlement; and (2) interest expense or income.

- Interest expense or income will now be net interest on the net defined benefit liability (asset), calculated by applying the discount rate to the net defined benefit liability (asset). This replaces the interest cost on the defined benefit obligation and the expected return on plan assets.

- Past-service cost will be recognised in profit or loss in the period of a plan amendment.

- A curtailment will only occur when an entity significantly reduces the number of employees. Curtailment gains and losses will be accounted for as past-service cost.

- A liability for a termination benefit will be recognised at the earlier of when the entity can no longer withdraw the offer of the termination benefit and when the entity recognises any related restructuring costs.

- Enhanced disclosures are required in order to present the characteristics of benefit plans and risks associated with them, and identify and explain the amounts recognised in the financial statements.

Background

The amendment has been included in the Memorandum of Understanding between the IASB and the FASB. Although there will still be significant differences, elimination of the options further aligns IFRS and US GAAP.

PwC observation: Further changes to the accounting for employee benefits, including contribution-based promises, will be considered in the IASB's consideration of the post-2011 agenda.

Both the IASB and the FASB have indicated that further improvements and convergence are desirable in the future.

pwc

Practical issues

The amendment will change reporting for certain types of benefits and raise a number of application issues, which are considered below.

Net interest cost

The amendment replaces the interest cost on the defined benefit obligation, and the expected return on plan assets with a net interest cost based on the net defined benefit asset or liability and the discount rate measured at the beginning of the year. The net defined benefit asset or liability is adjusted for actual benefit payments and contributions during the year. There is no change in the discount rate; this continues to reflect the yield on high-quality corporate bonds, or on government debt when there is no deep market in high-quality corporate bonds.

PwC observation: This is the most significant change in the measurement of employee benefit expense. It will increase the income statement charge for many entities because the discount rate is typically lower than the expected-return-on-assets assumption currently used. However, this change is neutral for total comprehensive income, as the reduction in profit or loss is offset by an increase in OCI.

Remeasurements

The amendment introduces a new term: 'remeasurements'. This is made up of actuarial gains and losses on the defined benefit obligation, the difference between actual investment returns and the return implied by the net interest cost and the effect of the asset ceiling. Remeasurements are recognised immediately in OCI and are not recycled.

PwC observation: The corridor and spreading method and the immediate recognition of actuarial gains/losses in profit or loss are no longer permitted. This will reduce diversity in presentation and will ensure that the balance sheet always reflects the extent to which a pension plan is funded. Amounts recognised in OCI are not recycled through profit or loss, but the standard no longer requires these items to be recognised immediately in retained earnings. This will allow remeasurements to be presented as a separate category within equity.

Past-service cost

The amendment changes the definition of past-service cost to clarify the distinction between curtailments and past-service costs; it also requires all past-service costs to be recognised immediately in profit or loss, regardless of vesting requirements. A plan amendment that reduces the defined benefit obligation will be a negative past-service cost, so there will be symmetry between the accounting for amendments that increase or reduce the obligation for past service. A curtailment will be the effect of a reduction in the number of employees participating in a plan.

PwC observation: IAS 19 currently requires unvested past-service costs to be recognised on a straight-line basis over the future service period until the benefits become vested; vested past-service costs are recognised immediately. The changes require management to recognise all past-service costs in the period of a plan amendment. Unvested past-service costs can no longer be spread over a future-service period. The amendment also removes the requirement to determine whether a benefit reduction was a curtailment or a negative past-service cost. Changes to benefits that reduce the defined benefit obligation will also be past-service costs.

Example

An entity operates a pension plan that provides a pension of 1% of final salary for each year of service, subject to a minimum of five years' service. On 1 January 20X1, the entity improves the pension to 1.25% of final salary for each year of service, including prior years. The present value of the defined benefit obligation therefore increased by C500,000, as follows:

	C
Employees with more than 5 years' of service at 1 January 20X1	400,000
Employees with less than 5 years' of service at 1 January 20X1 (average of three years of service so two years until vesting)	100,000
Increase in defined benefit obligation	500,000

Existing IAS 19

A past service cost of C400,000 should be recognised immediately, as those benefits have already vested. The remaining C100,000 is recognised on a straight-line basis over the two-year period from 1 January 20X1.

Amendment to IAS 19

A past service cost of C500,000 should be recognised and charged in the income statement immediately.

Settlement

The amendment clarified the definition of a settlement but did not make significant changes to the accounting for gains and losses on settlement. Settlement gain or loss is defined as the difference between (a) the present value on the settlement date of the defined benefit obligation being settled, and (b) the settlement price, including any plan assets transferred and any payments made directly by the entity. It is recognised in profit or loss when the settlement occurs.

The settlement gain or loss will no longer include unrecognised actuarial gains or losses, as these will be recognised immediately in OCI.

PwC observation: The amended standard clarifies that the payment of benefits provided in the terms of a plan and included in the actuarial assumptions – for example, an option at retirement for employees to take their benefit in the form of a lump sum rather than a pension or routine pension payments – are not settlements.

Risk and cost-sharing plans

The rising costs of post-employment benefits – arising from improving longevity, poor investment returns, legislative changes or increasing medical costs – have led to changes in plan design that do not always fit easily into the existing guidance. The amendment clarifies the accounting for features such as employee contributions or benefits that vary depending on the experience of the plan, contingent benefit increases relating to the investment performance of the plan and limits on the employer's obligation to contribute to a plan. It requires the expected cost of benefits to reflect all these plan terms, which may therefore require specific actuarial assumptions. For example, the cost of a benefit linked to investment returns will require an assumption about investment returns to be included in the expected increase in the pension.

PwC observation: Determining the substance of such arrangements, particularly constructive obligations beyond the contractual plan terms, will require judgement and significant disclosure. The substance of the benefit is also important to determine whether changes in actual benefits are plan amendments or actuarial gains or losses, and whether they affect profit or loss or OCI.

Example

Pension plan X has a long-established practice of providing cost-of-living increases to pensions in payment in line with the movement in a consumer price index (CPI). However, these are only awarded to the extent that the investment returns earned on plan assets are above a specific rate. There is no catch-up in future years for subsequent higher returns when an increase has been restricted due to the rate of return earned. The assumption regarding future pension increases should reflect not only expectations for the future movement in the CPI but also the expected returns on plan assets and the variability in those returns.

Taxes

Taxes payable by the plan are currently recognised in the return on plan assets. The amended standard requires taxes related to defined benefit plans to be included either in the return on assets or the calculation of the benefit obligation, depending on their nature.

Taxes on the return on plan assets will be part of the actual investment return and recognised in OCI. Social charges or other taxes levied on benefit payments or contributions to the plan should be included in the measurement of the defined benefit obligation to the extent that they relate to benefits in respect of service before the balance sheet date.

PwC observation: Entities are only affected if their current policy is different from the revised requirements. An entity that has to change its policy for taxes will be required to recalculate the defined benefit obligation, return on plan assets and the pension costs because the amendment is applied retrospectively.

Judgement is required to determine whether taxes should be included in the measurement of the defined benefit obligation or the return on plan assets. The revised standard refers specifically to taxes payable by the plan, but we believe taxes relating to benefits and paid by the employer should be recognised in the same way

Example

In territory X, pension plans are subject to income tax on investment income (interest, dividends and realised capital gains) and contribution income. The tax on investment income should be recognised in the actual return on assets. The tax on contributions should be recognised in the measurement of the defined benefit obligation based on the expected future contributions payable in respect of past service.

Administration costs and other expenses

The amendment requires costs associated with the management of plan assets to be deducted from the return on plan assets, which is unchanged from the existing standard. Other expenses such as record-keeping costs or actuarial valuation fees should be recognised in profit or loss when the services are received. This changes the existing standard, where there is a choice either to include expenses in the calculation of the defined benefit obligation or in the actual and expected return on plan assets.

The amendment gives a detailed definition how the return on plan assets is calculated:

Interest
+ Dividends
+ Other income
+/- Unrealised gains/losses
- Costs of managing investments
<u>- Taxes payable on investment returns</u>
= Total return on plan assets

PwC observation: Entities are only affected if their current policy is different from the new requirements. One example of this would be where costs other than investment management have been reflected in the expected and actual return. When a policy has to be changed, it may be necessary to recalculate the defined benefit obligation, return on plan assets and the pension costs, as the amendment is applied retrospectively.

Termination benefits

The amendment makes changes to the definitions and accounting for termination benefits to bring IAS 19 broadly into line with the US GAAP treatment of one-time termination benefits.

The changes clarify that any benefit that must be earned by working for a future period is not a termination benefit. A termination benefit is given only in exchange for the termination of employment. A benefit that is in any way dependent on providing services in the future is not a termination benefit.

The amendment also clarifies the identification of an obligating event when an employer offers voluntary termination benefits. A liability is recognised when the entity can no longer withdraw an offer.

Termination benefits and past-service costs can be very similar and may often arise as part of a restructuring. The amendment clarifies that:

- The gain or loss on a curtailment or plan amendment linked to a restructuring or termination benefit is recognised at the earlier of when the related restructuring costs or termination benefits are recognised and when the curtailment or plan amendment occurs; and
- Termination benefits linked to a restructuring are recognised at the earlier of when the related restructuring costs are recognised and when the entity can no longer withdraw an offer of the termination benefit.

PwC observation: The amendment removes an element of choice regarding whether some benefits are treated as termination or post-employment benefits. Management will have to assess whether termination benefits meet the new definition or are earned by working for a future period, in which case they would be classified as either a short-term, other long-term or post-employment benefit.

This changes existing benefits and not simply future terminations. Management should consider the timing of recognition for benefits that are termination benefits and whether an offer can no longer be withdrawn. Benefits that have been previously classified as termination benefits may be reclassified. This might result in later recognition of the related expense than the existing IAS 19.

Example

Management is committed to close a factory in 10 months and, at that time, will terminate the employment of all of the remaining employees at the factory. Management needs the expertise of the employees at the factory to complete existing contracts and announces the following plan.

Each employee that renders service until the closure of the factory will receive, on the termination date, a cash payment of C30,000. Employees leaving before closure of the factory will receive C10,000. There are 120 employees at the factory. Management expects 20 employees to leave before closure. The total expected cash outflows under the plan are C3,200,000 (20 × C10,000 + 100 × C30,000).

The entity accounts for benefits provided in exchange for termination of employment as termination benefits; it accounts for benefits provided in exchange for services as short-term employee benefits.

- *Termination benefits*
  The benefit provided in exchange for termination of employment is C10,000, which the entity would have to pay for terminating the employment without any future service. The entity recognises a liability of C1,200,000 (120 × C10,000) for the termination benefits at the earlier of when the plan of termination is communicated to the affected employees and when the entity recognises the restructuring costs associated with the closure of the factory.
- *Benefits provided in exchange for service*
  The incremental benefits that employees will receive if they provide services for the 10-month period are given in exchange for services provided over that period. They are accounted for as short-term employee benefits, as the entity expects to settle them within 12 months after the end of the annual reporting period. In this example, discounting is not required, so an expense of C200,000 (C2,000,000 ÷ 10) is recognised in each month during the service period of 10 months, with a corresponding increase in the carrying amount of the liability. Under current IAS 19, it could be argued that the whole amount of C3,200,000 meets the definition of a termination benefit and should be recognised when the closure and terms are announced.

Other long-term employee benefits

There is diversity in practice under the existing standard around whether the classification of the obligation as current or non-current under IAS 1 also drives the classification of the benefit as short or long term. The diversity arises because both standards use the term 'due to be settled', which is not defined.

The amendment clarifies the definitions of short- and long-term benefits by confirming that the distinction is based on whether payment is expected to be within the next 12 months or not, rather than when payment can be demanded. A long-term benefit could be a current liability when the entity does not have the unconditional right to defer settlement for more than 12 months.

PwC observation: Management should review the classification of short- and long-term benefits, and reclassify and remeasure obligations in accordance with the revised guidance. The accounting for short-term benefits remains unchanged and is generally simple, as no actuarial assumptions are required and any obligations are measured on an undiscounted basis. Long-term benefits are still accounted for in a similar way to defined benefit plans.

Example

Employees accrue a 20-day vacation entitlement rateably over the year. Unused entitlement can be carried forward indefinitely but is lost if not used before the employee leaves the company. Entitlement is utilised on a 'first in first out' basis.

Entity A has past experience that indicates that employees often carry forward their entitlement for a number of years, building up balances greater than 20 days. Entity B has past experience that indicates that employees utilise their entitlement such that they do not build up balances in excess of 10 days and typically use any carried forward entitlement in the next year.

Entity A concludes that the vacation accrual represents an other long-term benefit, as it does not expect to settle all the benefit within 12 months of the period in which it has been earned.

Entity B concludes that the vacation accrual represents a short-term benefit, as it expects to settle the benefit within 12 months of the period during which it has been earned.

PwC observation: Although the classification in Entity A and Entity B is different, this would only have a noticeable impact if the effect of discounting in Entity A was material to the liability. As the benefit is expected to be settled within a little over 12 months after the balance sheet date, if interest rates are low the impact may be small.

Interim reporting

The amendment does not make any consequential amendments to IAS 34, 'Interim financial reporting', to simplify the general requirements of IAS 19 in the context of interim reporting. However, the IASB notes in the Basis for Conclusions that an entity is not always required to remeasure a net defined benefit liability (asset) for interim reporting purposes under IAS 19 and IAS 34.

PwC observation: The removal of the corridor and spreading approach may increase the complexity of interim reporting for some entities. Those using this approach typically only remeasure the net defined benefit obligation between year ends in the event of a plan amendment, curtailment or settlement. Entities choosing to recognise actuarial gains and losses in OCI typically remeasure the defined benefit obligation and plan assets at each interim date to establish a gain or loss recognised in OCI. Service cost, interest cost and expected return on assets would not be recalculated unless there was a plan amendment, curtailment or settlement. The removal of the corridor and spreading options may make it necessary for an entity to value the obligation at each interim balance sheet date.

Back-end loading of benefit formula

Under IAS 19, defined benefits should be attributed to periods of service following the plan's benefit formula unless an employee's service in later years will lead to a materially higher level of benefit (and therefore current service cost) than in earlier years (back-end loading). Where this is the case, the benefits should be allocated to periods of service on a straight-line-basis.

The exposure draft stated that assumed salary increases should be considered in determining whether or not there is back-end loading. The Board concluded that this additional guidance should not be included in the final standard.

PwC observation: A conclusion that salary increases do not result in a plan benefit formula that is back-end loaded leads to inconsistencies in the treatment of plans providing economically identical benefits, depending on how those benefits are described in the plan documentation. Our view is that the current practice of including future salary increases in determining whether a benefit formula allocates a materially higher level of benefit to later years is appropriate.

Disclosure

The amendment introduces additional disclosures. The Board focused the disclosure objectives on the matters most relevant to the users of the financial statements. The amendment will require disclosure to:

- explain the characteristics of and risks associated with its defined benefit plans;
- identify and explain the amounts in the entity's financial statements arising from its defined benefit plans; and
- explain how the defined benefit plans may affect the entity's future cash flows regarding timing, amount and uncertainty.

There are many new disclosure requirements, including:

- *Risks specific to the entity arising from defined benefit plans*
  A narrative description of the specific or unusual risks arising from a defined benefit plan is required. Judgement will be required to identify those risks that should be explained, which may be challenging if there are many defined benefit plans with different characteristics within a group.
- *Categories of plan assets based on risks/nature*
  The amendment requires a breakdown of the plans assets into categories that distinguish the risk and liquidity characteristics and whether or not they have a quoted market price in an active market.
- *Actuarial assumptions*
  Entities are required to disclose the significant actuarial assumptions, together with a sensitivity analysis for reasonably possible variations in each of the significant actuarial assumptions. Judgement is required to determine which the significant assumptions are.
- *Reconciliations*
  A reconciliation between the opening and closing balances for plan assets, the defined benefit obligation, the balance sheet asset or liability and the effect of the asset ceiling will be required.
- *Future cash flows*
  Entities will be required to disclose significant information, in addition to the sensitivity analyses mentioned above, to help users understand the potential impact on cash flows, including:
  - a narrative description of any asset-liability matching strategies;
  - a description of the funding arrangements and funding policy;
  - the amount of the expected contributions in the next year; and
  - the weighted-average duration of the defined benefit obligation.
- *Extended disclosures for multi-employer plans*
  The accounting for multi-employer plans has not changed. However,

more information has to be disclosed for multi-employer plans. For example:

- a description of the funding arrangements;
- the extent to which the entity might be liable for other entities' obligations;
- qualitative information regarding any withdrawal liability unless it is probable that the entity will withdraw;
- an indication of an entity's level of participation in a plan (for example, proportion of total members); and
- the expected contribution in the following year.

PwC observation:
The disclosure requirements under current IAS 19 are extensive and sometimes difficult to understand. The amendment moves away from a checklist of items to an objective of providing relevant information when plans are material to the entity. However, the new requirements are likely to require more extensive disclosures and more judgement to determine what disclosure is required. Management should also be aware that some of the new disclosures may require additional actuarial calculations and should consider whether the internal reporting has to be updated to collect the new disclosures.

Transition

The amendment is effective for annual periods beginning on or after 1 January 2013; full retrospective application is required in accordance with IAS 8 'Accounting policies, changes in accounting estimates and errors', except for (a) changes to the carrying value of assets that include employee benefit costs in the carrying amount and (b) comparative information about the sensitivity analysis of the defined benefit obligation. Early adoption is permitted.

PwC observation: The amendment has to be applied retrospectively, which will require the disclosure of a third balance sheet in accordance with IFRS 1. There is an exception for assets that include employee costs so that assets such as inventory and property, plant and equipment that include employee benefits in cost do not have to be restated. This exception is not applicable for first-time adopters. The changes will also remove the employee benefits exemption in IFRS 1.

Next steps

Management should determine the effect of the revised standard and, in particular, any changes in benefit classification or presentation.

Management should consider the effect of the changes on any existing employee benefit arrangements and whether additional processes are needed to compile the information required to comply with the new disclosure requirements.

Management should also consider the choices that still remain within IAS 19, including the possibility of early adoption, the possible effect of these changes on key performance ratios and how to communicate these effects to analysts and other users of the accounts.