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IASB Proposes Changes to Accounting for Employers' Defined Benefit Plans

On April 29, the International Accounting Standards Board (IASB) released an Exposure Draft (ED) that would significantly alter how employers account for their post-employment defined benefit plan obligations. The ED would require immediate recognition in total comprehensive income for the fiscal year of changes in the value of plan assets and obligations due to experience gains or losses and plan amendments during the year, require the net funded position of the plan to be recognized as an asset (subject to a ceiling) or liability in the employer's balance sheet, and require the components of net plan expense to be presented in three different categories in the employer's total comprehensive income statement. The IASB work plan provides that final amendments will be issued in the second quarter of 2011, to be effective for 2013 fiscal years. The Financial Accounting Standards Board (FASB) is expected to consider these proposals in developing future changes to U.S. GAAP.

Background

In 2002, IASB and FASB agreed to work toward the long-term convergence of international and U.S. accounting standards with the goal of producing a single set of high quality standards. Accounting for post-retirement benefit plans was listed as an area in which each Board would initially work independently on a limited-scope Phase 1, with a mutual goal of full convergence later in a joint Phase 2 that would include review of the fundamental issues regarding measurement of employee benefit plan liabilities and expense. Each Board sought to respond to complaints from the users of financial statements that those statements did not sufficiently reflect the fair value of plans' assets and obligations and economic events that had occurred during the fiscal year, and that they were confusing and did not facilitate comparison between companies.

In 2006, FASB issued Statement of Financial Accounting Standards (SFAS) No. 158, which has since been codified in Accounting Standards Codification (ASC) 715. (See our October 9, 2006 *For Your Information*.) Last year, FASB expanded disclosures on plan assets and amended FSP FAS 132R-1 (now ASC 715-20-50). (See our January 14, 2009 *For Your Information*.) Finally, in March 2010, FASB announced the addition of another project to improve an employer's disclosure of its participation in a multiemployer plan (thus modifying ASC 715-80).

In March 2008, IASB launched its Phase 1 by releasing a discussion paper that described its tentative conclusions on recognition and presentation of the employer's obligation, and on accounting for hybrid plans (those with contribution-based benefits and minimum return promises). In 2009, IASB issued an ED with the limited objective of modifying the required discount rate for geographies without a deep market in corporate bonds, but this was later deferred to the joint Phase 2 along with the review of hybrid plan designs. Now, IASB has issued another ED, which only reflects IASB's views on changes to the IAS (International Accounting Standard) 19 requirements for recognition and presentation of employee benefit costs and obligations, and expanded disclosures.

The Exposure Draft

Changes to Annual Benefit Expense

The ED would eliminate both the current option under IAS 19 to defer recognition of changes in a plan's funded position due to experience gains or losses (including the effect of changes in actuarial assumptions), and the current requirement to amortize the change in obligation for nonvested benefits due to plan amendments over the remaining vesting period. Thus, all changes in the net funded status of employer plans during the fiscal year would have to be recognized in that year's benefit expense, and all changes in past service cost would be immediately recognized as part of service cost. Employers that have elected under IAS 19 to immediately recognize experience gain/loss through other comprehensive income (OCI) would not have a significant change to their total comprehensive income for the year (e.g., the UK has local accounting standards requiring immediate recognition of changes in a plan's funded position).

> ***BUCK COMMENT.*** *The immediate recognition of all changes in a plan's net funded status in that year's benefit expense can have a significant impact on the sponsor's service cost from year to year, greatly increasing its volatility and unpredictability.*

The ED does not address changes to the methods and assumptions used to determine the defined benefit obligation (including the use of the projected unit credit cost method and a discount rate based on high quality corporate bonds) or the value of plan assets (fair value must be used) for accounting purposes under IAS 19, with one exception. The ED explicitly provides that the measurement of the benefit obligation and current service cost should include an assumption regarding the cost of administering claims and benefit payments attributable to past service and any taxes payable by the plan on contributions or benefit payments relating to past service.

Changes to Presentation of Expense

In a joint project to reformat financial statements, FASB and IASB concluded that a single statement of total comprehensive income that would have a number of categories must be used to report the financial performance of the entity. The ED provides that the three components of annual benefit expense would be presented in different sections of the statement of total comprehensive income – employment, financing and remeasurement.

Employment. This component of P&L would consist of current service cost (i.e., the value of the benefit earned during the year), past service cost (i.e., the change in benefit obligation due to plan amendments) and changes in obligation due to a curtailment. (A curtailment is an event that significantly reduces the future years of service for current participants or reduces the rate of future benefit accrual for a significant portion of future service of current employees).

Financing. The net interest on the net defined benefit liability or asset would be presented as a financing cost included in P&L. This can be viewed as interest cost on the benefit obligation less the expected return on plan assets where the expected rate of return is equal to the discount rate used to determine the benefit obligation. However, if plan assets exceed the benefit obligation, the excess would be limited to the present value of future refunds or the reduction in future employer contributions.

> ***BUCK COMMENT.*** *This change would remove from annual expense a component equal to the expected return on plan assets for the year based on a rate justified by the investment policy of the sponsor. Eliminating the use of this return on assets assumption could lead sponsors to change asset mix because it reduces the short-term advantage of investing in equities.*

Remeasurement. Components not included in the employment and financing sections, consisting of gains/losses on the obligation (including the effect of changes in assumptions), actual return on the fair value of plan assets less interest at the discount rate on plan assets, settlement gains/losses, and changes due to asset ceiling adjustments, would be included in the remeasurement section of OCI.

> ***BUCK COMMENT.*** *Immediate recognition of gain or loss in OCI during a year might produce greater volatility in the balance sheet and total comprehensive income for that year as compared with the currently allowed corridor approach. Because P&L would only be affected in the succeeding year by interest on the gain/loss, volatility and unpredictability of net income and earnings per share could be reduced (there would be no subsequent amortization of the amount recognized in OCI into net income as under U.S. GAAP). Plans that are close to being fully funded may see a significant change in P&L if assets and obligations moved in different directions during the preceding year (as net interest cost changes from nearly zero to a sizable value).*

Changes to the Balance Sheet

In general, under current International Financial Reporting Standards (IFRS) accounting rules, the balance sheet of the plan sponsor shows a prepaid asset or accrued liability representing the excess of contributions (and benefit payments made directly by the employer) over expense charges. Because of the removal of the option to defer recognition of experience gains or losses and plan amendments affecting nonvested benefits, the net funded position of the plan would generally be recognized as a liability or asset on the balance sheet. The ED provides for the inclusion within IAS 19 of the guidance provided under International Financial Reporting Interpretations Committee (IFRIC) 14 for determining the limit on the net asset that can be recognized.

Changes in Disclosures

The disclosure provisions under IAS 19 would be completely restated.

Single Employer Plans

For single-employer plans, the disclosure information would include explanations of the characteristics of the plan, the amounts arising from the plan that were included in the financial statements, and the manner in which the plan may affect the amount, timing and uncertainty of the sponsor's future cash flows.

Plan Characteristics. The items covered by this category of information include the nature of the benefit formula (e.g., final average pay or cash balance), the effect of the regulatory framework in which the plan operates (e.g., minimum funding requirements, restrictions on net assets), and concentrations of risk in plan assets.

Amounts in Financial Statements. This information would include –

- reconciliations of plan assets, benefit obligations and the limits on the net assets
  - for each reconciliation, separate disclosure of
    - current service cost
    - past service cost
    - interest income or expense
    - effect of remeasurement (includes investment return in excess of the interest income on plan assets included in finance cost, gain/loss due to demographic assumptions, gain/loss due to changes in demographic assumptions, gain/loss due to changes in economic assumptions, gain/loss due to non-routine settlements)
    - curtailment gain/loss
    - employer contributions
    - employee contributions
    - benefit payments
    - effects of acquisitions or divestitures

- allocation of the fair value of plan assets into classes (i.e., employer stock, other equities, government debt, other debt and real estate), with a further allocation between those debt and equity securities that have a quoted market price in an active market and those that do not
- actuarial assumptions used to determine the benefit obligation
- the process used to determine demographic assumptions
- the benefit obligation excluding the effect of future salary increases.

Effect on future cash flows. This portion of the disclosure information would include the sensitivity of the benefit obligation reported at year-end and the current service cost determined for the year to a change in each significant actuarial assumption, and a description of the methods and assumptions used to develop these sensitivities. Techniques used to manage longevity risk and asset liability matching strategies would also be disclosed. The entity would also provide a discussion of how the net liability or asset of the plan will affect the level and timing of its contributions over the next five years and the period over which it expects the deficit or surplus to be eliminated.

> ***BUCK COMMENT.*** *Singling out the management of longevity risk for disclosure is misguided. Using current mortality improvement scales, each one-year update in mortality increases typical pension plan service cost by .2% - .3%, which is much less than most other risks pension plans create.*

Multiemployer plans

Under the ED, an employer participating in any multiemployer plan would now have to disclose the following –

- a description of the method used to determine the entity's rate of contribution and any applicable minimum funding requirements
- the extent to which the entity would be liable for the benefits for employees of other entities
- the number of the entity's active, retired and other participants in the plan and the proportion of these numbers to the total number covered by the plan
- details concerning any withdrawal or wind-up liabilities.

The proposed amendments to IAS 19 do not change the fundamental approach to accounting for the benefits provided under multiemployer arrangements. Thus, the entity is required to apply the rules for defined benefit plans (including the disclosure information noted above) unless sufficient information is not available. If information is insufficient, accounting for the multiemployer plan would be based on the rules for defined contribution plans, and additional disclosures would be required, including the reason why sufficient information is not available, the amount of expected contributions for the next five years, and the possible effect of the plan's surplus or deficit on future contributions.

Transition

IASB proposed that the changes to IAS 19 be applied retrospectively in accordance with the provisions of IAS 8. This would require entities to determine a cumulative adjustment to the earliest balance sheet presented and to present results under the amended IAS 19 for all comparative prior periods included in the first set of financial statements prepared after the effective date as if the amended standard had always been applied. As a result, the amount of unamortized past service cost and experience gain/loss as of the beginning of the earliest year presented would need to be recognized as an adjustment to equity. The pension expense reported in each of the years being reported would be determined under IAS 19 as amended, i.e., with immediate recognition of all past service cost and gain/loss.

> ***BUCK COMMENT.*** *Because many plan sponsors report two prior years alongside the current year, they may want to direct their actuaries to calculate plan expenses beginning in 2011 in compliance with this ED, so that the impact is known in advance. Plan sponsors may also want to review and modify their plans and policies now to possibly mitigate the impact of restatement in 2013 to reflect immediate recognition of past service cost and gain/loss that may significantly affect their 2011 or 2012 reported earnings.*

Next Steps

The comment period on the ED ends on September 6, 2010. IASB is expected to issue the amendments to IAS 19 in the second quarter of 2011, and is likely to adopt effective dates of January 1, 2013 or later.

> ***BUCK COMMENT.*** *Companies reporting under U.S. GAAP will be anxiously awaiting FASB's reaction to the ED. If the proposed amendments to IAS 19 were adopted by IASB, there would be basic convergence on recognition on the balance sheet of the net funded status of defined benefit plans and the cost of such plans recognized in the statement of total comprehensive income. The most significant difference between U.S. GAAP and IFRS would be the component of net periodic benefit cost representing the amortization for prior service cost and experience gain/loss included in P&L and the associated recycling of the amounts recognized in accumulated other comprehensive income to retained earnings in stockholders' equity. Because of the goals established in the 2002 Memorandum of Understanding between IASB and FASB for convergence and the milestones announced by the Securities and Exchange Commission (SEC) that will shape the SEC decision on implementation of IFRS for U.S. companies, FASB might well decide to adopt changes to ASC that would converge those standards in an expedited manner.*

IASB expects to publish a final separate amendment for termination benefits in the next few months. These changes were originally covered by a 2005 ED, but were put on the back burner as IASB dealt with IAS 37 (i.e., *Provisions, Contingent Liabilities and Contingent Assets)*.

IASB and FASB are each expected to release a comprehensive proposal on the preparation of a single statement of comprehensive income very soon. It would be reasonable to expect that any proposal will be consistent with the proposed changes to the presentation of pension expense included in the ED on benefits accounting.

Work on the joint Phase 2 project is not expected to begin until final amendments to IAS 19 are adopted and FASB completes its review of IASB action on the recognition and presentation issues presented in the ED.

Conclusion

The ED requests comments on questions posed about the proposed changes. IASB expects that costs to comply with the proposed changes should be minimal because existing standards already require entities to obtain much of the information required by the proposed amendments.

Buck's consultants are prepared to assist you in analyzing the effect of the ED on your operations and in preparing any comments to IASB that you would like to make.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.