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IASB Announces Changes to Accounting for Employee Benefits

On June 16, 2011, the IASB released an amendment to IAS 19 that significantly alters how employers account for their post-employment benefit plans. The amended standard requires 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 (including the effect of assumption changes) and plan amendments during the year. It also requires an employer to recognize the net funded position of the plan as an asset (subject to a ceiling) or liability in the employer's balance sheet. It replaces the expected return on plan assets as an element for determining benefit cost with an interest credit using the discount rate for measurement of benefit obligations. The amendments are generally effective for 2013 and later fiscal years, with earlier adoption permitted. Employers must apply the changes in accounting principles retrospectively. The FASB is expected to consider the IASB changes in developing future changes to U.S. GAAP. The FASB has not announced when it will begin to work on this topic.

Background

In 2002, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (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. In 2006, they added accounting for post-retirement benefit plans to this agenda but listed it 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. Phase 2 will include a review of the fundamental issues regarding measurement of employee benefit plan liabilities and expense. The Boards' reviews are in response to complaints from the users of financial statements that those statements do not reflect sufficiently the fair value of plans' assets and obligations and the impact of economic events that occur during the fiscal year. The users also complained that the statements are confusing and do not facilitate comparisons between companies.

Since the launch of its Phase 1 project in March 2008, the IASB issued a discussion paper and two exposure drafts (ED). The last ED, which was released in April 2010, presented the IASB's tentative conclusions on recognition and presentation of the employer's obligation and expense for employee benefits. The IASB received over 200 comment letters.

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IAS 19

On June 16, 2011, the IASB issued an amendment to International Accounting Standards (IAS) 19. The amended standard incorporates most of the significant changes proposed in the April 2010 ED. (See our May 7, 2010 *For Your Information*). The amended standard made changes to the following areas:

- Annual benefit expense;
- Presentation of expense; and
- Disclosures.

Changes to Annual Benefit Expense

The amended standard eliminates the option previously allowed for employers under IAS 19 to defer the recognition in expense of changes in a plan's funded position due to experience gains or losses (including the effect of changes in actuarial assumptions). It also eliminates the requirement for employers to amortize the change in obligation for nonvested benefits due to plan amendments over the remaining vesting period. Thus, employers will have to recognize in the current year's benefit expense all changes in the net funded status of employer plans during the fiscal year not arising from employer contributions. Employers will have to immediately recognize all changes in past service cost as part of service cost.

Total benefit expense will now have three major components:

- **Service Cost**. Service cost includes the value of benefits earned during the year and the change in the benefit obligation due to plan amendments, curtailments, and settlements, if any, occurring during the year. Service cost is recognized in profit or loss (P&L).
- **Net Interest Cost (Income)**. This is the net interest cost (income) on the net liability (asset) using the discount rate for measurement of the benefit obligation. Net interest cost (income) is recognized in P&L.
- **Remeasurement**. Remeasurement is intended to capture other changes in funded status not arising from employer contributions. Remeasurements are recognized in other comprehensive income (OCI).

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 total expense from year to year by greatly increasing its volatility and unpredictability. However, the impact on P&L will generally be much less volatile and unpredictable than under both U.S. and international current requirements. The substitution of the discount rate for the expected rate of return on plan assets in the P&L charge will generally reduce reported net income and earnings per share under IAS 19.*

The amended standard does not make any change to the methods and assumptions the employer must use to determine the defined benefit obligation under IAS 19. These accounting standards continue to require the use of the projected unit credit cost method and a discount rate based on high quality corporate bonds (except in countries where there is no deep bond market) to calculate obligations. The employer must continue to use fair market value of plan assets to determine a plan's net liability (asset) and benefit expense.

In the April 2010 ED, the IASB specified 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.

In the amended standard, the IASB adopted its proposal on taxes paid by the plan so that such amounts will have to be included in the measurement of benefit obligation to the extent that they relate to service before the reporting date or benefits related to that service. However, the amended standard did not adopt the ED position on administrative costs. Under the amended standard, employers will have to expense administrative costs as they are incurred. Employers will have to treat investment expenses and other taxes paid by the plan as a reduction to the actual return on plan assets (i.e., as part of the experience to be recognized as a remeasurement).

Employers will no longer consider a plan amendment that reduces the rate of future benefit accrual to be a curtailment but rather employers will have to include the resulting change in the benefit obligation in past service cost. This accounting is identical to the accounting for curtailments under the amended standard. IAS 19 now defines curtailment as a significant reduction by the employer in the number of employees covered by the plan. IAS 19 also clarifies that the term "settlement" only includes those payments that are not made in accordance with the existing terms of the plan. This eliminates from settlement accounting the single sum payments made to plan participants under the normal operation of the plan.

Changes to Presentation of Expense

In a joint project to reformat financial statements, the FASB and the IASB concluded that an employer must use a single statement of total comprehensive income with a number of categories to report the financial performance of the employer. The April 2010 ED would have required that the employer generally present the three components of annual benefit expense – service cost in the employment category, net interest cost in financing, and remeasurements in the remeasurement category – in different categories of the statement of total comprehensive income. The amended standard provides that the presentation of service cost and net interest cost in profit and loss should continue to be prepared in accordance with the prior version of IAS 19 (i.e., in accordance with the principles of IAS 1).

> ***BUCK COMMENT**. The joint FASB/IASB project on financial statement presentation that is currently underway will consider possible changes to the presentation of the components of net benefit expense in the statement of comprehensive income.*

Employers will include the components of annual expense – 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, and changes due to asset ceiling adjustments – in the remeasurement section of OCI.

> ***BUCK COMMENT***. *Immediate recognition of gain or loss in OCI during a year is likely to produce greater volatility in the balance sheet and total comprehensive income for that year as compared with the currently allowed corridor approach. However, the new standard will reduce the volatility and unpredictability of net income and earnings per share because there will be no subsequent amortization of the amount recognized in OCI into net income as is currently required under U.S. Generally Accepted Accounting Principles (GAAP).*

Changes to the Balance Sheet

In general, under the prior standard, 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 the new standard removes the option to defer recognition of experience gains or losses and plan amendments affecting nonvested benefits, the employer will generally recognize the net funded position of the plan as a liability or asset on the balance sheet.

Changes in Disclosures

The amended standard completely restates the disclosure provisions under IAS 19. Different rules apply for single employer plans and multiemployer plans.

Single Employer Plans

Sponsors of single-employer plans will have to disclose explanations of the characteristics of the plan, the amounts arising from the plan that are 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 will 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 and restrictions on net assets), and concentrations of risk in plan assets.
- **Amounts in Financial Statements**. This information will include reconciliations of plan assets, benefit obligations, and the asset ceiling on the net assets. For each of the reconciliations, the statement will have to include separate disclosure of current service cost, past service cost, interest income or expense, and the effect of remeasurement (including investment return in excess of the interest income on plan assets

included in cost). Also required is a break-down of the total gain and loss due to demographic experiences, changes in demographic assumptions, changes in economic assumptions, settlements, and curtailments. The employer must also disclose the effect of employer contributions, employee contributions, benefit payments, acquisitions, and divestitures. Similar to the requirements under U.S. standards, the employer should provide an allocation of the fair value of plan assets into classes (e.g., employer stock, other equities, government debt, other debt, and real estate), with the level of disaggregation as needed to meet the principles of the disclosures. The employer must disclose significant actuarial assumptions used to determine the benefit obligation and the benefit obligation excluding the effect of future salary increases.

- **Effect on future cash flows**. This portion of the disclosure information includes the sensitivity of the benefit obligation reported at year-end to a change in each significant actuarial assumption and a description of the methods and assumptions used to develop these sensitivities. Employers will have to disclose asset-liability matching strategies, any policy that affects future contributions, and the expected contribution for the next year. Employers will also have to discuss funding arrangements and the maturity profile of the benefit obligation.

BUCK COMMENT. *The new requirements may significantly increase the volume of disclosures included in the financial statements. The IASB decided to permit preparers to exercise judgment as to the specific items to be included, provided that the choice is consistent with the stated objectives of the disclosures.*

Multiemployer Plans

Under the amended standard, an employer participating in a multiemployer plan will have to describe the method used to determine the employer's rate of contribution, any applicable minimum funding requirements, and the extent to which the employer would be liable for the benefits for employees of other employers. The employer will also have to provide an indication of the employer's level of participation in the plan relative to other participating employers (e.g., the proportion of total members or total contributions) and a description of potential withdrawal or wind-up liabilities.

The amendments to IAS 19 do not change the fundamental approach to accounting for the benefits provided under multiemployer arrangements. Thus, the employer will generally be required to apply the rules for defined benefit plans (including the disclosure information noted above). If information is insufficient, the employer is to base accounting for the multiemployer plan on the rules for defined contribution plans. In that case, benefit expense will be equal to the employer contributions payable to the plan for service during the reporting period. Where there is insufficient information, employers will have to disclose the reason why sufficient information is not available, the amount of expected contributions for the next year, and the possible effect of the plan's surplus or deficit on future contributions.

Interim Reporting and Transition

Interim Reporting

The IASB decided not to require the employer to remeasure the net defined benefit liability or asset at each interim reporting date. However, if a material change in the funded status occurs during an interim period, the employer should remeasure at the end of the interim period and the remeasurement component of benefit expense recognized during such interim period should include the experience gain or loss since the last measurement date. The employer should base the service cost and net interest cost of the entire fiscal year on the assumptions used at the end of the prior fiscal year for annual reporting purposes.

Transition

The changes to IAS 19 are generally effective for fiscal years beginning on or after January 1, 2013 (earlier adoption is permitted) and must be applied retrospectively in accordance with the provisions of IAS 8. This requires 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, employers need to recognize the amount of unamortized past service cost and experience gain/loss as of the beginning of the earliest year presented as an adjustment to equity. The employer must determine benefit expense in each of the years being reported under IAS 19 as amended (i.e., with immediate recognition of all past service cost and gain/loss).

> ***BUCK COMMENT.*** *Under IAS 8, if an employer has not applied a new standard that has been issued but is not yet effective, it must disclose the date on which it will begin to apply the new standard and, if reasonably estimable, a discussion of the possible impact of the application of the standard on its financial statements. Thus, plan sponsors will need to direct their actuaries to calculate plan expense beginning in 2011 in compliance with the amended standard to gauge its impact on financial results and to be ready to comply with the retrospective application requirements.*

The new disclosures involving sensitivity analysis of changes in assumptions are required for fiscal years beginning in 2014 without retrospective application.

Conclusion

The IASB has now completed Phase 1 of its project on post-employment benefits. Both FASB and IASB have announced that they will focus their efforts in the near term on the completion of the remaining projects identified as high priority for the goal of convergence of accounting standards, such as revenue recognition, leases, and financial performance presentation. The joint Phase 2 project to review the basic elements of accounting for employee benefits will probably not begin until next year at the earliest.

The amendments to IAS 19 achieve basic convergence with U.S. GAAP on recognition on the balance sheet of the net funded status of defined benefit plans and the total expense under such plans, which are recognized in the statement of total comprehensive income. However, the IAS 19 amendments result in a greater disparity between IASB and U.S. GAAP in the amount of expense recognized within net income in accordance with the respective standards. 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 International Financial Reporting Standards for U.S. companies, FASB might decide to adopt changes to the Accounting Standards Codification that would reduce those differences in an expedited manner.

Buck's consultants are prepared to assist you in analyzing the effect of the amended IAS 19 on your operations.

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.