Global Report: IAS 19 Amendments for Employee Benefits

June 2011

On June 16, 2011, the International Accounting Standards Board (IASB) issued amendments to International Accounting Standard 19 (IAS 19) that overhaul employee benefit accounting under International Financial Reporting Standards (IFRS). These amendments are effective for fiscal years starting on or after January 1, 2013. Early adoption is permitted, but only if all of the amendments are adopted early.

Background

In 2008, the IASB issued a discussion paper that proposed significant changes to the accounting for employee benefit plans under IAS 19. Three years later, amendments to IAS 19 have been finalized and several of these initial proposals have been set aside to concentrate on key provisions that will dramatically revise the way employers recognize benefit cost.

As background, it is helpful to understand why the IASB decided to take on this project. Users of financial statements, including investors and analysts, had expressed concern about the lack of transparency in the methodology for employee benefit accounting that existed prior to the new amendments. In their opinion, the various smoothing mechanisms made it very difficult to truly understand the actual cost of providing these benefits in a given year. For example, analysts have pointed out the inconsistency that pension expense results reported for 2008 did not always include the large asset losses incurred in that year but instead, in some instances, still recognized gains from prior years.

The amendments issued a few days ago do not vary significantly from the Exposure Draft (ED) issued in 2010. The IASB accomplished the main goal of simplifying the accounting for employee benefit plans by removing the controversial smoothing mechanisms and requiring all companies to adopt a mark-to-market approach.
Scope
While the ED proposed to combine post-employment benefits and other long-term benefit plans into a single category referred to as “long-term employee benefit plans” so that the proposed changes would have impacted both types of plans, the final amendments retain the current IAS 19 benefit classifications and with this the different accounting treatment—i.e., remeasurements for other long-term benefits are recognized immediately in Profit and Loss (P&L)—and disclosure requirements.

Recognition
The IASB will now require an immediate recognition of all changes in plan assets and in the Defined Benefit Obligation (DBO) of post-employment defined benefit (DB) plans. This means that all actuarial gains and losses will be recognized immediately and in full in the financial statements in the period in which they occur and the existing option to defer recognition of gains and losses (the “corridor” approach) will be removed. Further, all past service costs, vested and non-vested, will have to be recognized in the period of the plan amendment. At the balance sheet level, this change is very similar to the FAS 158 changes made to U.S. GAAP in the mid 2000’s. Similar to the U.S. GAAP approach, all gains and losses are to be recognized in Other Comprehensive Income (OCI) in the period in which they occur. However, unlike U.S. GAAP where these amounts are subsequently amortized through P&L, there will be no such recycling under IFRS.

Aon Hewitt Comment
For companies that have historically deferred recognition of gains and losses, this change is likely to bring more volatility on the balance sheet as well as in total comprehensive income, especially for benefit plans holding significant amounts of non-matching assets.

Presentation
The IASB also changed the way benefit cost will be presented in company financial statements. The ED proposed that, in the statement of comprehensive income, entities would display separately the three components of employee benefit cost detailed below. However, in response to feedback received on the ED, the IASB decided to require disaggregation only in the footnotes to the financial statements. In the statement of comprehensive income, the IASB will give entities the choice to present service cost and interest cost either together, as a single net amount, or separately.
The three components of employee benefit cost are:

<table>
<thead>
<tr>
<th>Component</th>
<th>Included Items</th>
<th>Presented In</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service Cost</td>
<td>Service Cost</td>
<td>Profit and Loss</td>
</tr>
<tr>
<td></td>
<td>Plan amendment impact</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Curtailments</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Settlements</td>
<td></td>
</tr>
<tr>
<td>Interest Cost</td>
<td>Interest charge on balance sheet item</td>
<td>Profit and Loss</td>
</tr>
<tr>
<td></td>
<td>Actuarial gains and losses, including changes in assumptions</td>
<td>Other Comprehensive Income (OCI)</td>
</tr>
<tr>
<td>Remeasurement</td>
<td>Effect of changes to the asset ceiling</td>
<td></td>
</tr>
</tbody>
</table>

**Service Cost**

This component can be viewed as the benefits accrued during the fiscal period or the cost of providing one year of benefits. The IASB decided to include any benefit change that would affect past service in this component. The service cost component also will include any charges as a result of a curtailment (note, the distinction between a past service cost and a curtailment has been removed) and any settlements. The definition of settlements has been amended to clarify that these exclude any payouts that are recurring, expected events in the day-to-day operation of the plan; i.e., regular pension and lump-sum payments. While the IASB had initially proposed including settlements in the remeasurement component, the majority of those responding to the ED argued that presentation in service cost was more appropriate since settlements are generally driven by employer actions and can, therefore, be viewed as similar to plan amendments and curtailments.

**Interest Cost**

In an effort to remove all types of smoothing mechanisms, the IASB eliminated the concept of the expected return on assets which had enabled plan sponsors to book, in the income statement, an assumed return on plan assets and defer recognition of any gains and losses (i.e., the extent to which actual returns differ from assumed). Prior to the new amendments to IAS 19, the expected return on plan assets was offset by an interest charge on the DBO.

Under the new amendments to IAS 19, an interest charge will be booked in P&L calculated as the discount rate applied to the balance sheet asset or liability (i.e., the surplus or deficit adjusted for any asset ceiling or additional IFRIC 14 liability). Companies that currently use an expected rate of return higher than the discount rate (i.e., those that have significant investments in riskier, higher-returning assets) will, therefore, see an increased P&L charge; conversely, those that use an expected rate of return lower than the discount rate will see a reduced P&L charge.

**Aon Hewitt Comment**

*While IAS 19 only mentions that interest on the effect of the asset ceiling is to be included in net interest on the DB liability/asset, IFRIC 14 has been amended in line with the changes to IAS 19, and this makes it clear that any*
additional liability, where an entity is committed to deficit contributions in excess of the deficit on the IAS 19 basis, is part of the DB liability/asset, and thus, interest on this will be included in the IAS 19 net interest.

The removal of the expected return on assets is likely to encourage plan sponsors to be more conservative and implement a de-risking of investments, since it will remove an accounting-based incentive for investing in riskier assets. It also might encourage companies to use higher discount rates to minimize the deficit (and perhaps even show a surplus), thereby reducing the P&L charge for the plan.

**Remeasurement**

This component includes all gains and losses on the plan’s assets and liabilities that occur during the fiscal year as well as any changes in the asset ceiling (a ceiling on the amount of any plan surplus that can be recognized as an asset on the balance sheet). As detailed above, the remeasurement component will be presented in OCI.

*Aon Hewitt Comment*

Interestingly, this decision was the result of several heated discussions by the IASB. A proposal to provide employers the choice to present the remeasurement component in the P&L was initially welcomed by most IASB members but was eventually defeated by a narrow vote. The approach agreed to in this amendment can be viewed as a middle ground; analysts and other users of financial statements may be disappointed that not all costs related to providing benefits will be presented in the P&L, while most plan sponsors will be relieved that the volatility of their employee benefit plans will not be reflected in full in the P&L.

**Disclosures**

The amendments will not only change the accounting for employee benefit plans but also significantly increase the amount of information to be disclosed. The amendments do not provide a list of all required information but instead provide a series of disclosure objectives together with suggested disclosure details that, if considered material, might achieve meeting these objectives. The main objective of these enhanced disclosure requirements is to give investors more insight on the true nature of an entity’s DB plans by providing information about how the entity’s participation in the plans affects the amount, timing, and variability of its future cash flows. A sensitivity analysis for each significant actuarial assumption to which the entity is exposed will be required. The plan sponsor also may need to disaggregate disclosures to distinguish plans with materially different risk such as different geographical locations, different regulatory environments, different reporting segments, or different funding arrangements.

A summary of the new disclosure requirements can be found in the Appendix to this report.

**Other Provisions**

**Multiemployer Plans**

The IASB will introduce several changes to the disclosure requirements for companies that participate in multiemployer plans such as a more detailed description of funding arrangements as well as a narrative on the employer’s risk exposure from other employers withdrawing from the arrangement.
Aon Hewitt Comment
The IASB will, however, continue to pay close attention to the U.S. Financial Accounting Standards Board’s (FASB) current project on multiemployer plans and may introduce additional disclosure requirements in response to that project.

Attribution Where Benefits are Back-end Loaded
There are no changes to the current requirements around assessing whether a benefit formula attributes a materially higher level of benefit to future years; i.e., the proposal to clarify that expected future salary increases should be included in this assessment has been withdrawn.

Aon Hewitt Comment
The proposed clarification would have confirmed the methodology to be used in the valuation of Career Average (CARE) plans; i.e., the “project and pro-rate” methodology rather than the pure projected unit credit method. The IASB removed this clarification from the final changes as it believes this to be a measurement issue which is outside the scope of this project. Thus, there remains uncertainty around the valuation methodology for these types of plans. However, we believe that this should not be seen as a statement that salary growth should not be considered and expect audit firms will continue to express a preference for the “project and pro-rate” methodology, particularly as that is the method specified under U.S. GAAP.

Accounting for Plans with Risk Sharing or Conditional Indexation Features
Conditional indexation and risk-sharing features in a plan should be reflected in the measurement of the DBO.

Aon Hewitt Comment
This is to be understood as a clarification of the requirements already in IAS 19 and we would not expect this to change the valuation methodology used previously.

In particular, the amended IAS 19 includes some new paragraphs relating to any allowance required for the impact of employee contributions. We understand that this is NOT intended to change how the DBO is measured under current IAS 19. That is, where employee contributions are fixed (independent of the funded status of the plan), these are treated as a reduction to the service cost when they are paid. Where employee contributions are dependent on the funded status of the plan (i.e., there is risk sharing involved), they have to be taken into account in the determination of the DBO.
Administration Expenses

Previously under IAS 19, the most common practice for recognizing administration costs was to reduce the expected return on assets assumption. Now that the expected return assumption is no longer required, the IASB initially proposed an alternative approach that would essentially include a present value of future administrative costs in the DBO. Ultimately, the IASB dropped this proposal and decided that the cost of managing plan assets should be deducted from the return on plan assets and, thus, be presented in OCI. All other administrative costs should be recognized in P&L in the year they occur (this is not clear from the text of the amended IAS 19, but the intention is indicated in the Basis for Conclusions). The option to capitalize administrative costs in the DBO has been removed from IAS 19.

Other Amendments

There are some further, more minor, changes to IAS 19. For instance, the definition of termination benefits has been clarified so that benefits that are conditional on some future service (e.g., stay bonuses) will be classified as post-employment benefits or other long-term employee benefits (as appropriate). Additionally, the difference between a short-term and a long-term employee benefit has been clarified, with short-term benefits being benefits that are expected to be settled within less than 12 months of the reporting date.

The IASB also changed the timing of recognition of certain plan amendments, curtailments and settlements, and termination benefits to require recognition of such events that are related to a restructuring when the related restructuring cost is recognized.

Effective Date and Transition

The amendments to IAS 19 are mandatory for accounting periods starting on or after January 1, 2013. Early adoption is permitted, but only if all of the amendments are adopted early. Early adoption must be disclosed in the accounts.

There are no special transition requirements, which means that transition is in accordance with the general requirements of IAS 8 and IFRS 1; i.e., entities would apply the proposed amendments to IAS 19 retrospectively. In practice, this means that transition is by restating the start of the comparative period with any initial adjustment arising from the application of the change being recognized in retained earnings. Note that in the first year of adopting the new standard, no comparative information for the new disclosures is required.

Next Steps

As with any significant changes in legislation or accounting principles, plan sponsors should carefully study the impact of these amendments on their financial statements. We expect that many sponsors will factor these changes into decisions on future investment strategy, which may result in lower allocations to risky assets, a move towards liability-driven investment strategies, and perhaps even an increase in trends to plan termination.
Appendix

Below are the new disclosure objectives for post-employment DB plans, together with the new suggested disclosure details. An entity’s judgment is required to determine the level of detail, amount of aggregation/disaggregation, and possible additional information required to meet the disclosure objectives.

An entity shall disclose information that:

- Explains the characteristics of its DB plans and risks associated with them, e.g.:
  - Information about the characteristics of the plan including:
    - The nature of the benefits provided;
    - Details of the regulatory framework in which the plan operates and its effect on the plan; e.g., minimum funding requirements; and
    - A brief description of any other entity’s responsibilities for the governance of the plan.
  - A narrative description of any unusual risks specific to the plan or the entity; and
  - Details of any plan amendments, curtailments, and settlements.

- Identifies and explains the amounts in its financial statements arising from its DB plans, e.g.:
  - Separate reconciliations from the opening balance to the closing balance for the net DB liability/asset, the plan assets, the DBO, and the effect of the asset ceiling. The amendments detail the individual line items that are to be provided in each of these reconciliations;
  - Disaggregation of 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 and those that do not (the standard provides a list of possible classes to disclose);
  - Fair value of the entity’s own transferable instruments, property occupied by the entity, or other assets used by the entity which are included in plan assets; and
  - Significant actuarial assumptions used to determine the present value of the DBO.

- Describes how its participation in DB plans affects the amount, timing, and variability of the entity's future cash flows:
  - Sensitivity analysis of the significant actuarial assumptions used to determine the DBO, as well as the methods and assumptions used in creating the sensitivity analysis;
  - Details of any asset-liability matching strategies to manage risk;
  - A narrative description of any funding arrangements and policies that affect future contributions;
- The expected contribution to the plan for the next reporting period; and
- Details regarding the maturity profile of the benefit obligation, including the weighted average duration of the DBO and possibly other information about the distribution of benefit payments.

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If you would like further information about accounting for post-employment or other long-term employee benefit plans, please contact your local Aon Hewitt consultant.
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