Deloitte.

May 2010

IAS Plus Update.

Closing the Corridor – IASB proposes significant changes to pension accounting

On 29 April 2010 the International Accounting Standards Board (IASB or Board) published Exposure Draft ED/2010/3 (ED) *Defined Benefit Plans – Proposed amendments to IAS 19.* Although the IASB decided not to carry forward some of the more fundamental proposals contained in the March 2008 discussion paper (DP) *Preliminary Views on Amendments to IAS 19*, there is no doubt that the proposals in the ED, if finalised, would have a significant effect on many entities with defined benefit plans. Although the financial statement impact will vary from entity to entity, many can expect to report lower net income, have less net income volatility but an increase in other comprehensive income (OCI) volatility and recognise a larger liability or smaller asset in the statement of financial position. The proposals may also cause an entity to become more conservative in its investment strategies relating to its defined benefit plan which could lead to higher costs of providing the associated benefits. The potential impacts of the proposals are discussed in more detail below.

IAS 19 is often criticised for permitting deferred recognition of actuarial gains and losses and its ambiguity in other areas which has resulted in a lack of transparency and diversity in practice. The Board believes the ED addresses the areas that have historically received criticism and makes other necessary improvements to the recognition, presentation and disclosures of defined benefit plans. The comment letter deadline on the ED is 6 September 2010. The IASB will conduct further outreach activities to interested parties during the comment period to gather views on the proposals.

Key proposals

The ED proposes several significant changes to the current requirements under IAS 19.

Elimination of the corridor method

The proposal to eliminate the option to apply the corridor method is likely to have the most significant impact in practice. The corridor method permits an entity to defer a portion of actuarial gains and losses that fall outside a specified corridor (being the greater of 10% of the defined benefit obligation (DBO) or 10% of the fair value of plan assets).

With the elimination of the corridor approach, all actuarial gains and losses would be recognised immediately through OCI and the net pension asset or liability recognised in the statement of financial position would reflect the full amount of the overfunded or underfunded status of the benefit plans. The option to recognised actuarial gains and losses in profit or loss is removed.

Although the proposal to eliminate the corridor approach is likely to be criticised by many entities during the comment letter process, the Board is seeking to respond to concerns regarding net income volatility by requiring the actuarial gains and losses to be recognised in OCI rather than in profit or loss.

Example

An entity's defined benefit plan has assets of CU50 and a defined benefit obligation of CU70 at the end of the current period. In the current year the plan incurred an actuarial loss of CU10 due to changes in the expected costs of providing the benefits and changes in the value of plan assets. Assume there are no actuarial gains or losses in prior periods and the average remaining life of the employees participating in the plan is 10 years.

The corridor is calculated to be CU7 (being the greater of 10% of CU50 or 10% of CU70). Under the corridor approach, the entity would be permitted to recognise a minimum amount of 0.3 (being the actuarial loss outside the corridor of CU10 – CU7 = CU3, divided by the average remaining life of the employees participating in the plan of 10 years) in the next reporting period but it could also choose to apply a method resulting in faster recognition if applied consistently over time.

IAS Plus website

We have had almost 11 million visits to our www.iasplus.com website. Our goal is to be the most comprehensive source of news about international financial reporting on the Internet. Please check in regularly.

Actuarial loss in current year	10
Actuarial results in prior periods	0
Less: the corridor	(7)
Excess	3
Minimum amount that must be recognised	0.3

Under the ED, the entity would be required to recognise the CU10 loss in the current period within OCI, thereby bringing recognition of the actuarial loss forward into the current period and at its full amount.

Change in presentation approach

The ED proposes a new presentation approach for changes in defined benefit obligations and the fair value of plan assets. Entities would segregate changes in the defined benefit obligation and the fair value of plan assets into those associated with (1) service costs, (2) finance costs and (3) remeasurement.

- ***Service costs*** – service costs would be recognised in profit or loss. Curtailments and past service costs resulting from plan amendments would be recognised as costs of the period in which the plan amendment takes place, regardless of whether the related benefits are vested or not. This change eliminates the need to distinguish between curtailments and negative past service costs.

- ***Finance costs*** – net interest expense would be presented as part of financing cost in profit or loss (currently, the presentation of interest expense within profit or loss is an accounting policy choice). Further, net interest income or expense would measure the expected change in the surplus or deficit due to the time value of money (the finance cost component would not include the part of the return on plan assets that does not arise from the passage of time). Net interest expense would be calculated by applying a single high quality corporate bonds discount rate to the net defined benefit liability or asset. The difference between the actual return on plan assets and the change in plan assets resulting from the passage of time would be recognised in OCI as a remeasurement component.

In many cases, using the rate representing the market yields on high quality corporate bonds could reduce net income, since net income would not reflect the benefit from the expectation of higher returns on riskier investments. Some entities believe that this could encourage more conservative investing which could then lead to a higher cost of providing the associated benefits.

- Remeasurement Components

  Actuarial gains and losses: these would include experience adjustments and the effects of changes in actuarial assumptions on the defined benefit obligation, i.e. those actuarial gains and losses related to the costs of *providing* the benefits. Actuarial gains and losses would no longer be affected by the *expected* rate of return on plan assets as the Board believes that an entity's expectations about the return on plan assets are less relevant than the actual return on plan assets and the Board is concerned that the subjectivity inherent in determining the expected rate of return could lead to abuses.

  Return of plan assets (net of the time value of money): this amount would include income earned from the plan assets as well as realised and unrealised gains or losses on these assets and would be reduced by the net interest expense recognised as a financing cost in profit or loss and by costs incurred to manage the plan assets.

  Gains/losses on non-routine settlements: whether routine or non-routine, gains and losses on settlement represent experience adjustments (the difference between the defined benefit obligation and the actual settlement price). Accordingly, all settlement gains and losses are recognised in OCI. To the extent that the gain or loss arises on a non-routine settlement, the ED proposes that it should be presented as a separate element of the remeasurement component (gains/losses on routine settlements would be presented as part of actuarial gains and losses).

  Changes in the limitation in recognition of net defined benefit asset: an entity with a plan surplus would continue to measure the net defined benefit asset at the lower of the surplus in the defined benefit plan and the present value of any refunds from the plan or reduction in future contributions to the plan.

The ED specifies that amounts recognised in OCI are immediately transferred to retained earnings and are not accumulated in a separate other comprehensive income reserve.

Disclosure

To improve the clarity of the information disclosed with respect to defined benefit plans, the Board proposes to set out the following objectives to guide the preparation of these disclosures:

- Explain the characteristics of an entity's defined benefit plans.

- Identify and explain the amounts in the financial statements resulting from those plans.

- Describe how future cash flows (amount, timing and uncertainty) may be affected by the defined benefit plans offered by the entity.

Under the ED proposals, the disclosures provided by entities would:

- Be simplified by the elimination of the option to defer actuarial gains and losses.
- Include further quantitative information on actuarial assumptions including separate disclosure of actuarial gains and losses arising from changes in demographic and financial assumptions and sensitivity analyses about actuarial assumptions used to determine the defined benefit obligation. Entities would also need to disclose the present value of the defined benefit obligation, adjusted to exclude the effect of projected growth in salaries (commonly referred to as the "accumulated benefit obligation").
- Include further narrative information on risks associated with defined benefit plans and the investment strategy for the plan assets, including the factors that could cause contributions over the next 5 years to differ from current service cost.

Entities involved in multi-employer plans would be required to present significantly more information than at present to allow users of financial statements to appreciate better the risks arising from an entity's participation in such plans.

Entities will need to consider how to gather the information necessary to prepare meaningful disclosures, such as the extensive sensitivity analysis. Further, entities may need to call upon the actuaries involved in determining the funding needs of the defined benefit plans in order to prepare disclosures about the factors that may affect the level and timing of contributions in the future.

Other proposed changes

Classification of employee benefits

The ED proposes to simplify the classification of the different employee benefits arrangements by grouping in a single category long-term employee benefit arrangements that are currently defined as "post employment benefits" and "other long-term employee benefits". As a result, all long-term defined benefit arrangements would be recognised and measured in the same manner and would be subject to the same disclosure requirements.

The ED also proposes to change the factors used to determine whether an employee benefit plan is short-term or long-term. Short-term benefits are restricted to plans that are expected to be settled within 12 months after the end of the reporting period in which the related services have been rendered and before the completion of employment.

All other employee benefits plans (except termination benefits) would be considered as long-term employee benefits.

The classification between short-term and long-term based on the expected settlement date rather than the date the obligation becomes due, as is currently required in IAS 19, may result in more plans being classified as long-term employee benefit plans (that is more plans that would need to be measured using actuarial assumptions and accounted for using the projected unit credit method).

Tax and administrative costs

The ED proposes to eliminate the option currently available in IAS 19 to include plan administrative costs either as a reduction of the return on plan assets or as an adjustment to the defined benefit obligation. Instead, the ED specifies that only costs relating to the management of the plan assets would be presented as a reduction of the return on plan assets. To the extent that future administration costs relate to the administration of benefits attributable to current or past service, the present value of the defined benefit obligation should include these costs. The effect on profit or loss of this proposal will depend on whether the current accounting policy is to expense immediately these amounts or to include them in the corridor calculation.

The ED also clarifies that current service cost would include taxes payable by a plan on contribution and benefits relating to services rendered before the reporting date.

Future salary increases

The ED proposes to remove a source of ambiguity in IAS 19 by specifying that future salary increases must be considered in determining whether a benefit formula results in employee's service in later years contributing to materially higher level of benefit than in earlier years. When this is the case, the benefit must be recognised on a straight-line basis.

Issues not addressed by the ED

Since the objective of the Board in publishing this ED is limited to addressing issues that have been the subject of significant criticisms and other issues that can be easily fixed, certain aspects remain unaddressed. In particular, the Board decided not to reopen the discussion on the requirement to use the rate on government bonds as the discount rate when there is no deep market for high quality corporate bonds. Further, the difficulties relating to the accounting for certain cash balance plans (that the DP attempted to capture as contribution-based promises) remain unaddressed.

The Board believes that resolution of these issues requires a fundamental review of accounting for defined benefit promises and that such a project cannot be undertaken by the Board at this time due to its many commitments.

Further, the ED does not propose to change in any significant manner the determination of the asset ceiling requirements. It proposes mainly to incorporate the requirements of IFRIC 14 directly in IAS 19. However, in the absence of deferral of actuarial gains and losses and past service cost, the calculation of the asset ceiling limits should be easier.

Transition

The Board proposes that entities should apply the proposed amendments to IAS 19 retrospectively, in accordance with IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors.*

Next steps

The Board expects to finalise the amendments to IAS 19 by June 2011. The Board has not decided on the effective date for the amendments. In accordance with a general policy announced in December 2009, the Board will consider collectively the effective dates for standards to be completed by 30 June 2011. Generally, the Board intends that the effective date for these projects will not be earlier than 1 January 2013.

The Board is also expected to publish in the second quarter of 2010 amendments to the accounting for termination benefits, based on an ED published in 2005.

IFRS global office
Global IFRS Leader – Technical
Veronica Poole
vepoole@deloitte.co.uk

IFRS centres of excellence

Americas		
New York	Robert Uhl	iasplusamericas@deloitte.com
Montreal	Robert Lefrancois	iasplus@deloitte.ca
Asia-Pacific		
Hong Kong	Stephen Taylor	iasplus@deloitte.com.hk
Melbourne	Bruce Porter	iasplus@deloitte.com.au
Europe-Africa		
Brussels	Laurent Boxus	BEIFRSBelgium@deloitte.com
Copenhagen	Jan Peter Larsen	dk_iasplus@deloitte.dk
Frankfurt	Andreas Barckow	iasplus@deloitte.de
Johannesburg	Graeme Berry	iasplus@deloitte.co.za
London	Elizabeth Chrispin	iasplus@deloitte.co.uk
Madrid	Cleber Custodio	iasplus@deloitte.es
Moscow	Michael Raikhman	iasplus@deloitte.ru
Paris	Laurence Rivat	iasplus@deloitte.fr
Rotterdam	Ralph ter Hoeven	iasplus@deloitte.nl

For more information on Deloitte Touche Tohmatsu, please access our website at www.deloitte.com

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in 140 countries, Deloitte brings world-class capabilities and deep local expertise to help clients succeed wherever they operate. Deloitte's 150,000 professionals are committed to becoming the standard of excellence.

Deloitte's professionals are unified by a collaborative culture that fosters integrity, outstanding value to markets and clients, commitment to each other, and strength from cultural diversity. They enjoy an environment of continuous learning, challenging experiences, and enriching career opportunities. Deloitte's professionals are dedicated to strengthening corporate responsibility, building public trust, and making a positive impact in their communities.

Deloitte refers to one or more of Deloitte Touche Tohmatsu, a Swiss Verein, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu and its member firms.

This publication contains general information only and is not intended to be comprehensive nor to provide specific accounting, business, financial, investment, legal, tax or other professional advice or services. This publication is not a substitute for such professional advice or services, and it should not be acted on or relied upon or used as a basis for any decision or action that may affect you or your business. Before making any decision or taking any action that may affect you or your business, you should consult a qualified professional advisor.

Whilst every effort has been made to ensure the accuracy of the information contained in this publication, this cannot be guaranteed, and neither Deloitte Touche Tohmatsu nor any related entity shall have any liability to any person or entity that relies on the information contained in this publication. Any such reliance is solely at the user's risk.

© Deloitte Touche Tohmatsu 2010. All rights reserved.

Designed and produced by The Creative Studio at Deloitte, London. 3932A