

Response by the Accounting Standards Subcommittee of the Pensions and Employee Benefits Committee of the International Actuarial Association to the IASB note of 8 November 2002

The following response to your email of 8 November has been prepared by the Accounting Standards Subcommittee of the Pensions and Employee Benefits Committee of the International Actuarial Association. The subcommittee includes representatives from Australia, Finland, Germany, Ireland, Norway, UK and USA. The response has been circulated for comments to the Pensions and Employee Benefits Committee for additional input, but has not been subject to the due process required for it to constitute a formal view of the IAA. We would expect to make our response to the Exposure Draft of changes to IAS19 in due course subject to full due process however so that these will represent an official view.

Issues arising from the post-employment convergence project

- 1 Recognition of actuarial gains and losses: the Board has tentatively agreed that actuarial gains and losses should be recognised immediately, ie that the corridor and spreading options within IAS 19 should be removed. However, it was accepted that such a proposal could not be taken forward until the proposals for performance reporting were finalised.

RESPONSE

We recognize that there has already been considerable correspondence relating to the immediate recognition of actuarial gains and losses, and believe the IASB is well aware of the arguments that have been put forward to date by the actuarial profession and others in various countries. Please note, however, that we are not supportive of immediate recognition of actuarial gains and losses, given the long-term nature of the liabilities and the need to make best estimate assumptions for the long term. Instead, transparency of the finances of the defined benefit plan can be provided by disclosure of the mark to market values of the assets and liabilities, supplemented by a breakdown of the plan's assets into the major asset classes. The market can then take its own view as to the effect the defined benefit plan has on the company's performance and over what time frame.

If there is to be immediate recognition, this should be via a vehicle similar to the STRGL under FRS 17.

The immediate recognition of gains and losses in the company's

accounts may have consequences for the operations of defined benefit plans globally, which the IASB recognizes in question 8 below. In this regard, the impact that FRS 17, which has immediate recognition (albeit through the STRGL), has already started to have on the operation of defined benefit plans in the UK, and corporate attitudes to investment strategy in those plans (if not a closure of them), is notable. If the IASB were to adopt immediate recognition too, it can be assumed that similar effects may be repeated in other major occupational pension countries globally. It is possible that the implications on the labour markets and demand and supply in equity and bond markets would happen overtime in any case, as companies and their investors reappraise the nature of companies liabilities/obligations in changing economic conditions, but a change in accounting practice of the magnitude in question would contribute to, if not catalyze, such activity.

2 The asset ceiling: the Board considered whether there should be a limit on the amount that can be recognised as an asset in respect of a surplus in a defined benefit plan. It agreed that the principle to be followed was that an entity should recognise as an asset the rights the entity has to benefit from the surplus. In measuring those rights, the following hierarchy should be followed:

- value the entity's rights to refunds and reductions in future contributions. If this is less than the surplus, then
- value the entity's rights to fund increased benefits to current and future employees. No value should be ascribed to the entity's right to fund increased benefits to past employees. If these two items together are less than the surplus, then
- value the entity's right not to fund future losses in the plan to the extent that the losses will be absorbed by the surplus.

Can you advise on valuation methods for the third bullet? Is it a practical thing to ask entities to do?

RESPONSE

In general, we support the concept of limiting surplus where the plan sponsor cannot benefit directly from the surplus. When we consider the intent of the Board in this area, it appears that you have concerns about limiting surplus too much. There will be times when the surplus is higher than the value of the amounts that can be obtained through a reduction in future contributions or a refund of surplus. We do not see that as a particular problem.

We are concerned about the frequent use of the word "right". In most trust-based arrangements consent of more than one party is typically required. The Board may want to refer to the language from FRS 17, which is conceptually the same, but more appropriate.

Regarding the second bullet, we have a number of concerns. We are now talking about contingent future events, which seem to be inconsistent with the direction being followed by the IASB. We see no reason to include the value of increased benefits for future employees, since no allowance for future employees is made within the prescribed (Projected Unit Credit) valuation method. There seems to be little reason to exclude past employees if they continue to be included in the valuation of the liabilities. As for actually valuing this “right”, do we assume that the benefit increases can continue to the maximum permissible in the particular country’s legislation? If so, this will result in little restriction of surplus, even though the use may be limited and highly unlikely. To conclude, we believe the second bullet should be eliminated.

In terms of the third bullet, rather than advising on valuation methods, we would rather this bullet be eliminated, again because we’re straying into trying to allow for contingent future events.

- 3 US literature: the Board considered the differences between the guidance provided in IAS 19 and FAS 106 *Employers’ Accounting for Postretirement Benefits Other Than Pensions* and decided:
 - a. to include in an appendix or implementation guidance to IAS 19 guidance on the identification of a substantive non-pension post-employment benefit plan similar to the guidance in FAS 106
 - b. to include in an appendix or implementation guidance to IAS 19 guidance on the selection of assumptions unique to health care post-employment benefit plans similar to the requirements and guidance in FAS 106, to the extent that the requirements and guidance in FAS 106 do not conflict with IAS 19
 - c. to amend IAS 19 to require the recognition of potential changes in state health care benefits where the state benefits have been ‘substantively enacted’ (rather than the present requirement for reliable prediction), similar to the requirements of IAS 12 *Income Taxes*
 - d. to require an analysis of the sensitivity of health care post-employment benefit plans to changes in the assumed health care cost trend rates
 - e. to review whether the sensitivity of other post-employment benefits plans to key assumptions such as inflation should be disclosed in accordance with the proposals in [Draft] IAS 1 *Presentation of Financial Statements*
 - f. to require the separate disclosure of post-employment benefit plans where the plans are subject to materially different risks, instead of

the present encouragement of such disclosure.

RESPONSE

We agree with the direction of this item, and, in particular, support item f. - the requirement to separately disclose post-employment benefit plans rather than the present encouragement of such disclosures. We are, however, concerned about the additional work and its associated cost in providing the sensitivity analyses under items d. and e.

- 4 The expected return on assets: IAS 19 requires the total change in value of plan assets to be split into an expected return and the difference between the expected return and the actual return. The expected return is currently reported in income and the difference between the expected return and actual return is treated as an actuarial gain and loss, the recognition of which is currently allowed to be deferred. The Board had previously agreed that there should be no deferral of actuarial gains and losses (see above). The Board further tentatively agreed that no expected return on plan assets should be presented separately. Instead the total change in value of all plan assets should be presented in the proposed second, remeasurement, column of the performance statement. It was agreed that the Board would reconsider this issue after its discussion of the net presentation/consolidation of the pension plan in the balance sheet (planned for the November meeting).

RESPONSE

We have concerns about this approach. As we read it, the Board is suggesting that there be no expected return on assets reported in income. If we continue with the concept of immediate recognition of gains and losses, we would have expected to continue to have an expected return reported in income, with the difference between the expected return and actual return presented in the remeasurement column of the performance statement. If the proposed approach is taken, it may lead to an incorrect picture of the economics of the retirement plan. It appears inconsistent to have an interest cost element of pension expense based on the past service liabilities, but no expected return element based on the plan's assets.

- 5 Allocation of costs to periods of service: in order to determine the liability that exists at any balance sheet date, it is necessary to allocate the benefits earned to each accounting period. For benefits that vest in the same period as they are granted, there is no issue – they are earned in that period. For benefits that vest over some future period, the current requirements in IAS 19 for current service cost and past service

cost are complex and inconsistent. The Board agreed that unvested benefits should be allocated between the date of grant and the vesting date on a straight-line basis.

The recognition of benefits in this way would be based on the unit of benefit that has vested. The measurement of that unit of benefit will be based on the measurement requirements of IAS 19. So, for example, for a plan that provides no benefits for the first 19 years of service and a vested benefit of \$10,000 for the 20th year, the benefit would be attributed on a straight-line basis over the twenty years to the vesting date. For a plan that provides for 1% of final salary for each year of service, the vested unit of 1% would be recognised each year and measured on a basis that reflects final salary, even though some of that benefit measured on that basis is unvested at the balance sheet date.

Finally, the Board agreed that any benefit allocated to the current or past periods will be recognised immediately. This will have the effect that there will be no unrecognised past service cost relating to unvested benefits (as there currently can be under IAS 19): to the extent that increased benefits are allocated to past periods, their cost will be recognised immediately and to the extent that they are allocated to future periods, there is no effect on the liability at the balance sheet date and hence no past service cost to recognise.

This approach to unvested benefits is based on the view that there is no economic substance to the benefit formula whilst the benefits are unvested. However, I have since been informed that, at least in the US, the situation is that if a plan is closed, the employees are entitled to benefits (or compensation for their loss) based on the benefit formula even though the benefits had not vested. Can you advise me whether that is generally the case?

RESPONSE

If the Board's overriding principle is the immediate recognition of all gains and losses, we can understand your position of recognizing past service costs immediately. In the overall operation of a retirement plan, we would expect that benefit improvements would typically be considered when there has been favourable experience. Since that favourable experience is expected to be reflected on the balance sheet (through something consistent with the STRGL under FRS 17) rather than through the income statement, we would expect the cost of past service benefit improvements to also be reflected on the balance sheet rather than through the income statement.

In your last (bolded) paragraph, the example given appears to be discussing a situation when the plan is being terminated rather than closed to new entrants. If that is the case, then we do not believe the issues to be relevant, since accounting principles normally call for the assumption of a going concern.

- 6 Consolidation and balance sheet presentation: the Board will consider whether some defined benefit plans should be consolidated by the entity and how the assets/liabilities should be presented in the balance sheet. (To be considered at the November Board meeting).

RESPONSE

We concur with the opinion of the IASB staff that a net approach to the presentation of assets and liabilities is desirable.

- 7 Definitions of defined benefit plans, defined contribution plans and plan assets: The IAS 19 definition of a defined contribution plan requires there to be no legal or constructive obligation to pay further contributions relating to past service. Any plan that has such an obligation is a defined benefit plan. This is different to the FASB definitions, which are based on the allocation (or not) of contributions to individual accounts. (The plan is defined contribution if amounts are allocated to individual accounts and defined benefit if they are not.) In addition, the FASB comparison of US GAAP with IASs suggests that the IAS 19 definition of a defined contribution plan could include plans that would normally be regarded as defined benefit if they are in surplus and the entity is not required to pay contributions while the plan is in surplus. (To be considered at the December Board meeting.)

The definitions of plan assets under IAS 19, US GAAP and Canadian GAAP are different. (To be considered at the December Board meeting.)

RESPONSE

Any attempt to adequately describe all possible scenarios relating to the definition of defined benefit plans, defined contribution plans and plan assets will be next to impossible. We propose that the Board instead consider a principle-based definition for each. Any necessary clarification for a particular situation could be addressed through Q&A examples.

- 8 Mitigation of problems that may arise from the immediate recognition of actuarial gains and losses: Actuarial gains and losses can be very large amounts and very volatile. A proposal of immediate recognition is likely to be controversial. Recognition of pension plan deficits may also give rise to problems with distributable reserves for European companies. In addition to the presentation of actuarial gains and losses in the income statement (which will be discussed in the project on reporting performance), the Board may wish to consider how the resulting pension asset or liability should be presented in the balance sheet and the question of exemptions in their individual accounts for

group companies that participate in a group-wide (and therefore multi-employer) plan. (To be considered at the December Board meeting.)

RESPONSE

We also agree that the proposal of immediate recognition of gains and losses will be controversial. However, if this is the direction of the IASB, and the concept stretches well beyond retirement and other post-employment benefits, we cannot foresee an approach to mitigating the problem that wouldn't be viewed as arbitrary. We look forward to hearing how the Board will look to address this issue.

7 January 2003

Issues being considered by the International Financial Reporting Interpretations Committee (IFRIC)

- 9 Application of IAS 19 to money purchase plans with a minimum return guarantee: such plans are defined benefit plans under the definitions in IAS 19. IFRIC will consider issuing guidance on how the defined benefit methodology in IAS 19 should be applied.

RESPONSE

We agree that a money purchase plan with a minimum return guarantee should be considered a defined benefit plan.

- 10 Multi-employer plans: IAS 19 exempts some multi-employer plans from defined benefit accounting. IFRIC will consider issuing guidance on when this exemption is available.

RESPONSE

Our solution to this issue would be to approach it in a manner similar to accounting for equity (minority) interests versus subsidiaries. If a company's "holding" in the multi-employer plan exceeds a pre-determined percentage, then they can reasonably expect to be able to influence the decisions for that plan. If the holding is small, there is little chance to influence, and exemption from defined benefit accounting is warranted.