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Clearly IFRS

Moving ahead in an IFRS world
A practical guide to implementing

IAS 19 (2011) – Employee Benefits

Contents

Providing you with clarity and perspective

With the IFRS adoption process fairly recently completed, Canadian entities may be surprised by the number of significant new IFRSs that are effective in 2013. The key standards with a mandatory 2013 adoption date are IFRS 10 *Consolidated Financial Statements*; IFRS 11 *Joint Arrangements*; IFRS 12 *Disclosure of Interests in Other Entities*; IFRS 13 *Fair Value Measurement* and IAS 19 (2011) *Employee Benefits*. This list doesn't include some of the smaller amendments to pre-existing standards such as the consequential amendments to IAS 27 (2011) *Separate Financial Statements* and IAS 28 (2011) *Investments in Associates and Joint Ventures* arising from the issuance of IFRS 10, 11 and 12.

The impact of these new and amended standards may be significant for some entities. Fortunately for Canadian companies, you have your recent IFRS conversion experience to help you tackle these new standards.

> A comprehensive listing of new and amended standards and the related effectives dates is available on our IAS Plus website (www.iasplus.com/en/standards/standard3). The same level of information is also available on interpretations (http://www.iasplus.com/en/standards/interpretations/interp1)

About IAS 19 (2011)

IAS 19 (2011) ("IAS 19R") is an amended standard with changes focused on a number of specific areas – most notably the area of defined benefit plan accounting, but also the definitions (and therefore the measurement of) short and long-term benefits, employee termination benefits and disclosures. For some entities, the amended standard will have a significant impact; for others this change may be more limited. There will be change though, as the scope of the standards is broad and extends to more than pensions. The key, of course, is determining where your entity falls on this scale so that you can identify and spend time on those areas which matter most to you. The Deloitte team has assembled this guide to kickstart your efforts, and better enable you to make this assessment. In this guide, we get straight to the key principles of IAS 19R so that you can obtain an appreciation of the standard and identify the issues that are most relevant to you.

I hope that you find this guide helpful and encourage you to reach out to me or one of my colleagues for additional support as needed. Our contact information can be found at the end of this document.

Karen

Karen Higgins, FCPA, FCA
National Director of Accounting Services

At a glance

The IASB issued the revised standard on Employee Benefits in June 2011 and the standard is effective for years commencing on or after January 1, 2013 with early adoption permitted.

The revised standard (IAS 19 (2011) or IAS 19R) requires full retrospective application with limited exceptions. For entities with defined benefit plans ("DB Plans"), the core change that the standard brings is the requirement to recognize the full deficit – or surplus – of a defined benefit plan on the statement of financial position with the previous cost deferral mechanism (i.e. the corridor method) no longer being permitted.

For many entities, the most significant change in the measurement of employee benefit expense on a recurring basis will be, the introduction of the net interest concept which, for funded plans and in the current environment, can be expected to have a negative impact on profit or loss ("P&L").

Under the existing guidance in IAS 19, P&L includes the interest cost on the defined benefit obligation. This interest cost is calculated using one rate (the discount rate). P&L under IAS 19 also includes income on the assets of the plan calculated using another rate (representing the expected rate of return on plan assets). In Canada, in the current environment, the latter rate is generally higher. IAS 19R replaces interest cost and the expected return on plan assets with a single net interest component which is largely calculated by applying a single discount rate to the net difference (positive or negative) between the defined benefit obligation and the fair value of the plan assets.

Other changes introduced by IAS 19R include a variety of discrete items that the IASB considered capable of resolving within what is essentially a limited scope project – for example, the introduction of three components into which changes in plan assets and the defined benefit obligation are to be segregated as well as clarifications and additional guidance relating to termination benefits. As may be expected, disclosure requirements have been enhanced and the time commitment to address these should not be under-estimated.

"The amendments to IAS 19 will ensure that investors and other users of financial statements are fully aware of the extent [of] and financial risks associated with those commitments"

Sir David Tweedie, 16 June 2011

The Canadian landscape

Prevalence of defined benefit plans

There has been a downward trend in the number of entities who offer defined benefit plans in Canada. Such plans, consistent with their title, effectively secure the benefit entitlement of a plan participant and, in contrast to defined contribution plans, place the risks of investment performance, with the entity. The move away from such plans is arguably the result of a decreased appetite to take on such risk and an increasing preference of entities to lock-down the cost today and avoid some of the uncertainty and potential funding issues that could arise in the future. This said, while there may be some move away from defined benefit plans, many employers still have a sizeable legacy liability related to the benefits which have accrued over prior years. Accordingly, unless a plan settlement is imminent, the risks and exposures related to such plans, and the accounting implications for them, are very much present in the Canadian landscape.

Increased transparency

A related talking point in the current environment is the solvency position of defined benefit plans. The solvency of a plan refers to whether or not a plan has sufficient assets to fund the benefits that have been earned to date. Where there is a solvency deficiency, an entity will be required to make payments to reduce or eliminate this position. The immediate recognition treatment of actuarial gains and losses required under IAS 19R means that there will be greater visibility into the risks and funding status associated with defined benefit arrangements. The full extent of any plan deficit or surplus will be recognized on the statement of financial position[1]. For many Canadian entities, this level of transparency may already be present depending on the policy choice made during IFRS transition. As you may recall, Canadian adopters had a policy choice available on transition to IFRS – either to retain the corridor method (mirroring the policy of choice for many under Canadian General Accepted Accounting Principles ("GAAP") at that time), or to adopt a new policy of immediate recognition of actuarial gains and losses, through other comprehensive income ("OCI"). IAS 19R will level the playing field through the elimination of the deferral mechanism enabling enhanced comparability between all entities with DB plans.

The choices made on transition to IAS 19R are presented later in this document (see section entitled – "How do you measure up?") along with our insights thereon. Before this, however, is our synopsis of the key changes related to defined benefit plan accounting under IAS 19R, identifying what we consider to be the key changes and providing insights and consideration to help frame the implications of each key change.

There has been a downward trend in the number of entities who offer defined benefit plans due to the risks that reside with the employer and the funding and investment performance issues that are a factor of the current economic environment.

IAS 19R – Changes related to defined benefit plans

About the change	Our comments
Immediate recognition of actuarial gains and losses (now part of "**remeasurements**" – see below) in OCI.	• This change will be of significance to those entities currently applying the corridor method. The elimination of alternative policy choices currently available under IAS 19 should serve to enhance comparability between entities with defined benefit plans.
Costs are classified based on their nature as: • **Service cost** (P&L[2]) • **Net interest** (P&L) • **Remeasurements** (OCI)	• Canadian entities will need to learn the new terminology and assess the appropriate categorization for changes in the defined benefit obligation and plan assets. • This may not be a straightforward exercise for some items. The guidance does not explicitly address all costs that may be incurred and it may be necessary to consult interpretative guidance as well as your auditors and professional advisors.
Service cost is calculated as the total of: • Current service cost • Past service cost • Gains and losses arising on plan settlements.	• Past service cost may arise following a change in the plan terms (i.e. a plan amendment). The impact on the defined benefit obligation is required to be recognized immediately under IAS 19R. Previously, to the extent there was any unvested element (e.g. minimum service period), such amounts would be deferred and amortized but this treatment is no longer permitted. • Plan amendments and plan settlements often occur together and it is not always easy to segregate the impact of these two events when they occur together. IAS 19R aligns the treatment and classification of the costs related to plan amendments and settlements thereby easing the practical application of the accounting requirements in this area.
Net interest is determined by applying the discount rate (used to measure the defined benefit obligation or DBO) to the net defined benefit liability (asset) of the plan.	• "Net interest" is a new concept intended to represent the net cost of financing the obligation. It isolates the change arising from the application of the discount rate to the asset and liability. • Net interest is included in profit or loss and replaces two individual components (the interest cost and the expected return on plan assets) previously recognized in profit or loss under IAS 19 (prior to the amendments). • This will be a significant change for funded plans and will generally result in an increase in pension expense relative to IAS 19. This is because, for the majority of Canadian plans, the expected long-term rate of return on plan assets is higher than the discount rate. Accordingly, there will no longer be a positive difference between the expected return on plan assets and the accretion of the defined benefit obligation. See section 'The discount rate' later in this guide for additional detail. • Any excess of the expected or actual rate of return on plan assets over the discount rate is recorded within OCI as part of remeasurements.

About the change	Our comments
Remeasurements are recorded in OCI and are comprised of actuarial gains and losses on the DBO, the return on plan assets net of the interest income component (included in net interest) and any change in the asset ceiling (excluding any amount required to be included in net interest).	• Remeasurements represent changes in the value of the plan assets and in assumptions relative to actual experience attached to the DBO. • The classification and treatment of remeasurements is based on the premise that these represent changes in value which fundamentally differ from costs directly related to employee service or the funding of a benefit plan. • Note that remeasurements include all changes in the value of plan assets other than the net interest portion which is driven by the discount rate (see above). Previously, the expected return on plan assets was included in net income. There will be a P&L impact on transition to IAS 19R based largely on the percentage difference between the two rates applied to the fair value of the plan assets.
Remeasurements are not subject to recycling through profit and loss. However, the prescribed requirement of an immediate transfer of actuarial gains and losses to retained earnings has been removed.	• The removal of this immediate transfer requirement gives entities the ability to maintain a separate reserve within equity for accumulated remeasurements, to elect a policy choice to leave in accumulated other comprehensive income ("AOCI") or to perform a transfer to retained earnings each reporting period.
Costs related to the management of plan assets are deducted from the return on plan assets (i.e. part of remeasurements). All other plan administration costs must be recognized in P&L.	• Under IAS 19R, only those costs of managing the plan assets (i.e. investment-related administration costs) should be recognized as part of the return on plan assets (and therefore through OCI). All other administration costs are recognized as incurred in P&L. Some degree of estimation may be necessary where costs related to the management of plan assets are part of an overall fee.
IAS 19R[3] clarifies that the estimate of the **DBO includes the present value of taxes payable** by the plan if they relate to service before the reporting date and are imposed on benefits resulting from that service. Other taxes are included as a reduction to the return on plan assets which will impact remeasurements in OCI.	• Taxes payable of this nature are now specifically identified as a financial actuarial assumption. Canadian entities will need to ensure the DBO incorporates this assumption, when applicable, which effectively means such taxes will impact service cost. • The standard does not address country specific tax regimes (e.g. refundable taxes on retirement compensation arrangements). Nor does it address the treatment of taxes paid by the employer on behalf of the employee. Accordingly, consultation with your auditors and professional advisors and consideration of interpretative guidance is recommended.
The treatment of **contributions from employees or third parties** is contingent on whether or not they are "linked to service". Where such contributions are deemed to be linked to service, then they are attributed to periods of service as a negative benefit which reduces the service cost line item in P&L. Otherwise contributions are treated as remeasurements and recorded in OCI.	• The determination of whether or not a contribution is linked to service may be subjective at times and judgment may be required in determining the reason why an employee (or a third party) is required to contribute to the plan. • The requirement for attribution as a negative benefit, for contributions linked to service, has resulted in questions as to how, in practice, this guidance should be applied. At the time of writing, the matter is under consideration by the IFRS Interpretations Committee. Depending on the conclusions of these discussions, this guidance may represent a significant change from current practice and could have a substantive impact on service cost for some entities[4].

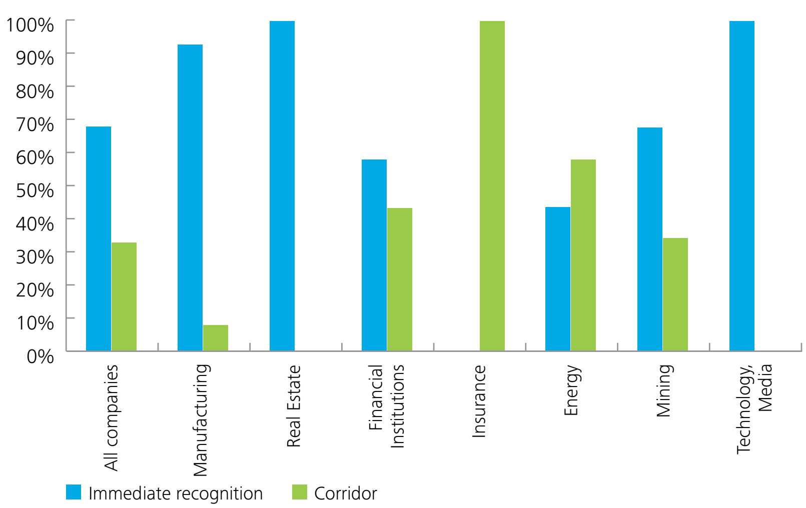
How do you measure up?

So, what is the starting point for your entity? How do you compare to other Canadian entities in general and within your industry sector?

One data point that you may find a helpful is a study[5] we conducted of the choices made upon the mandatory adoption of IFRS in Canada in 2011. In this study we looked at the policy choices that Canadian companies made around the treatment of actuarial gains and losses upon the initial adoption of IFRS relative to Canadian GAAP.

We observed that 68% of the companies included in our population elected to change their Canadian GAAP accounting policy on transition to IFRS. The motivations for the choice selected evidenced some degree of industry element. In the real estate and technology industries there was a 100% "take-up" rate of the policy choice of immediate recognition of actuarial gains and losses through OCI. The converse was true for the insurance sector, as no entities in the population used for our study selected the IFRS policy option of recognition of actuarial and gains and losses immediately through P&L. Industry trends aside, it would generally seem reasonable to conclude that anticipation of the elimination of the corridor method, coupled perhaps with the ability to recognize any volatility through other comprehensive income, made the immediate recognition approach the preferred policy choice for the majority of Canadian entities.

IFRS transition – policy choice by industry



Transition from the corridor

The largest impact on transition to IAS 19R will be felt by those entities that retained the corridor approach on transition to IFRS. As evidenced by the graphical analysis, entities in the insurance sector and energy sector are most likely to fall into this category. In bringing the full extent of the obligation, and plan assets, onto the balance sheet, the impact on net equity may be sizeable. Given the fact that the vast majority of Canadian plans are in a funding deficit at this time, the impact will more often than not be downwards (i.e. a charge to equity on adoption of IAS 19R).

While this will better convey the solvency of defined benefit plans to key stakeholders, this may also raise questions like: "How does the entity expect to fund the plan?" or "When can we anticipate a healthier financial portrait of the plan?" Such matters could cause pressure on regulatory capital, key performance indicators and debt covenants. Entities should refer to our implementation checklist at the end of this guide, in order to be well placed to answer these questions in the event they later arise.

Transition from immediate recognition

Where an entity selected the immediate recognition policy option on transition to IFRS then this will most certainly serve to downsize the initial equity impact and the adoption of IAS 19R will, in many cases, be less significant. Entities falling into this category should nonetheless be prepared for change. The introduction of net interest in IAS 19R will result in a higher charge to the P&L for many entities with funded plans and the more stringent segregation of movements into the components identified by the amended standard will be unfamiliar territory for all entities.

There is certainly a need to be mindful of those changes which have been less well-socialized in conjunction with the changes to IAS 19R – for example, the area of employee contributions, retirement compensation arrangements and administration costs. Last but not least, some focus on the changes outside of defined benefit plans is required. The key changes we have identified follow in the next section.

IAS 19R – Other areas of change

About the change	Our comments
The definitions of **short-term** and **other long-term benefits** have been amended to clarify that this distinction is based on the date when the benefit is expected to be settled. The existing text in IAS 19 uses the term "due to be settled" resulting in a potential interpretation that it was entitlement (as opposed to expected timing) that governed the classification basis.	• This clarifies what is for some a substantive measurement issue since short-term benefits are not discounted whereas for long-term benefits discounting to present value is required. • The change in terminology may be significant for entities with substantive benefit plans where benefits are carried forward for many years. For example, benefits related to paid time off may be contractually due to be settled in the short-term but are often expected to be settled over a long period of time. The result of this change may be that some benefits previously treated as short term may now be presented as long-term and measured on a discounted present value basis.
The definition of a **termination benefit**, and the related recognition criteria, have been amended. The amendments are intended to differentiate termination benefits from post- employment benefits and benefits which are conditional on future service.	• The amendments better highlight that the key differentiator for a termination benefit is the fact that it is the termination which is driving the payment of the benefit. • A careful read of this guidance is needed. The requirements are now better aligned with US GAAP, however some differences still remain. Canadian entities familiar with these requirements should bear this in mind.
Presentation requirements are largely unchanged. While the new cost component classifications determine whether an item should go through P&L or OCI, as with the existing standard, there is no requirement to present these items separately. **Disclosure** requirements on the other hand have been substantively amended with the identification of clear disclosure objectives and some onus on the preparer to determine how these objectives will be most effectively met.	• The disclosure requirements are organized by disclosure objective and set out quite differently to IAS 19[6]. • The defined objectives are focused on disclosures which 1) set out the attributes of a plan and related risks; 2) help a user understand the composite of the amounts reported; and 3) enable comprehension of the impact on future cash flows. • The level of required granularity and the emphasis on differing requirements are based on an assessment by the entity of what matters most to users. This will entail differentiating between the need for transparency (and compliance) and concerns around including too much data at the risk of obscuring relevant information on the plan.

The discount rate

A reasonable question to ask as you go through the amendments may be, "what about the discount rate?"

With the current economic environment and the issuance of an educational notice[7] in 2011 by the Canadian actuarial profession, there has been a renewed focus on the methodology used to determine the discount rate. Additionally, some actuarial firms have started to revisit the methodology they have been using to date. The methodologies, and reviews thereof, are focused on the extrapolation of yields on high-quality corporate bonds where the population (for longer time horizons) may be lacking.

While IAS 19R did not amend the guidance on the discount rate, the focus on the discount rate may increase with the IAS 19R amendments. The full recognition approach mandated by the revised standard means the effect of the discount rate and periodic changes thereto will be more evident in the financial statements through additional potential volatility in income as compared to the corridor method.

Additionally, from an income statement standpoint, the determination of net interest expense means that the return on plan assets recognized is effectively capped at the discount rate used to value the defined benefit obligation. This will likely result in a higher pension expense by virtue of the fact that the discount rate is generally lower than the rate of return on plan assets. This is a significant change and best illustrated by a practical example.

An entity has a defined benefit plan and has a policy of immediate recognition of actuarial gains and losses in OCI under IAS 19. Summary data with respect to this plan is as follows:

Table 1: Plan data

Selected key assumptions		**Plan position ($M)**	
Discount rate (A)	4%	DBO or Defined benefit obligation (C)	(1,500)
Expected return on plan assets (B)	5%	Fair value of plan assets (D)	1,000
		Net defined benefit liability (E)	(500)

The actual return on plan assets for the period was also 5% and so $50M (i.e. 5% of $1000).

The benefit expense for the period calculated under IAS 19 includes 4% interest on the DBO ($60M expense) and 5% return on plan assets ($50M income). The net impact of these amounts is a $10M charge to P&L (all other aspects of benefits expense are ignored for simplicity). This is shown on the left hand side of the table shaded in blue. Shifting gears to IAS 19R, the expected rate of return on plan assets is no longer a component of overall benefits expense. Rather, the discount rate of 4% is now applied to plan assets to give interest income of $40M. There is no change to the calculation of interest expense. The net impact of IAS 19R is a $20M charge to P&L – a $10M decline relative to IAS 19. This is shown on the right hand (unshaded) side of Table 2, below.

Table 2: IAS 19 vs. IAS 19R

IAS 19			**IAS 19R**		
		$M			$M
Interest expense (A x C)	4% x $(1,500)	(60)	Interest expense (A x C)	4% x $(1,500)	(60)
Expected return on plan assets (B x D)	5% x $1,000	50	Interest income		40
Net impact of the above under IAS 19		(10)	Net interest under IAS 19R (A x E)	4% x $(500)	(20)

[The references A through D in Table 2 above are derived from Table 1: Plan data]

The actual performance on plan assets of $50M does not change at all of course – it is a real transaction and not the product of an assumption. Under IAS 19, any difference between the actual and expected return on plan assets (zero in this example) would be recorded in OCI as an actuarial gain or loss. In contrast, under IAS 19R, the difference between the actual return on plan assets and the discount rate applied to plan assets is recorded in OCI as a remeasurement.

The total of the interest cost and actual returns under 19 and 19R are the same – it is only the allocation between P&L and OCI which has changed with a $10M income entry under IAS 19 now being recognized directly in OCI under the new requirements of IAS 19R.

The last word

This guide provides you with a general sense of the key changes and how they may impact your entity. The next step is putting our words into actions for your entity, now that you have some idea of the level of impact and attention this amended standard will require. It is important to note that this guide has been written in a deliberately condensed way – it is not a substitute for the standard and nor is it intended to address specific complexities your entity may encounter. However, it should enable your entity to determine if and where you do need additional support.

With limited exception, IAS 19R is to be adopted on a full retrospective basis. Remember that on adoption of a new or amended standard, the requirements are applicable from the first interim period that falls within the annual period in which a standard becomes effective – so March 31, 2013 for calendar-year ends. Canadian reporting issuers will also need, in most instances, to present a third statement of financial position as at the start of the earliest comparative period presented under NI 51-102 *Continuous Disclosure Obligations* which requires the inclusion of such a statement upon the retrospective application of a new accounting policy. This third statement of financial position (i.e. as at January 1, 2012 for calendar year-end companies adopting IAS 19 (2011) in 2013) is also an annual financial statement requirement under IAS 1 *Presentation of Financial Statements*. Materiality considerations may, in some instances, allow for the exclusion of the third statement of financial position – for example, in a case where the standard has no impact on an entity for all periods presented.

Implementation

3 steps to 'GET' on track with IAS 19R

Implementation requires a move away from just words and into actions – **G**ather information, **E**valuate the impact and **T**ransition. A summary of how to **"GET"** ready for IAS 19R is in the table to the right. Accounting for employee benefits may remain a complex area but we hope this guide has given you a better understanding of the requirements of 19R and the impact on your entity.

Step 1 Gather information	Step 2 Evaluate the impact	Step 3 Transition to IAS 19R
Pulling together all of the different data points you need to implement 19R – everything from the standard itself, to facts related to your entity, to preliminary resource identification.	Getting into the nuts and bolts of what 19R means and identifying the pressure points for your entity. This will entail a review of your old policy and consideration of policy changes to be made.	Combining information attained and decisions made in the first two stages in order to implement the new standard.

Detailed consideration points

Step 1	Step 2	Step 3
Defined benefit plans Gather information covering: • Plan basics (open or closed plan, funded or non-funded, contributory or non-contributory) • Key assumptions • Recent or pending changes • Administration and management fees • Other relevant attributes	**Defined benefit plans** Identify key aspects of your policy that will change and possible impacts. For example: • Immediate recognition • Equity classification of remeasurements • Net interest • Map plan costs (income) to the IAS 19R cost buckets (service, net interest, remeasurements).	**Defined benefit plans** • Determine when you are going to implement (Jan 1, 2013 or earlier for calendar year-ends). • Remember that adoption is as of the beginning of the immediately preceding comparative period, and as such, reporting (including comparative data) starts in the first quarter of 2013. • Don't forget to consider the requirement for the third (opening) statement of financial position. • Work with your actuary to effect changes from Q1. • Disclose preliminary impact in pre-implementation financials (IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*).
Other areas Inventory balances and transactions such as: • Long and short-term benefits • Terminations (recent past or pending) Make enquiries around potential ancillary impacts (e.g. tax).	**Other areas** • Identify benefits classified as short or long-term and reassess against the new definition. • Assess any impact related to the amount or timing of liability and expense recognition for termination benefits. • Consider incremental disclosures and how you want to address the new requirements (additional layer vs. start afresh).	**Other areas** • Communicate major changes as required to other stakeholders.

Resources

- Internal: HR/benefits, Tax
- External: Auditors, actuaries, educational material.
- Q2 2012: IFRS quarterly technical update - Moving ahead in an IFRS world
- IFRS in Focus: IASB amends accounting for post-employment benefits

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Endnotes

1 Actuarial assumptions used for GAAP financial statements may differ in some instances than those used by actuaries to perform a plan valuation for regulatory purposes.
2 The recognition through P&L or OCI is applicable except to the extent that another standard requires or permits their inclusion in the cost of an asset. For example, where an employee is engaged on the construction of an item of PP&E, cost capitalization may be appropriate under IAS 16 in lieu of the treatment following the IAS 19 classification of the cost.
3 IAS19R.76b(iv)
4 For further information, see the November 2012 IFRIC Update.
5 Deloitte Canada conducted a study analyzing approximately 100 medium to large calendar year end, Canadian reporting issuers with an IFRS adoption date on or after January 1, 2011.
6 The basis for conclusions to IAS 19R provides a summary of the changes in BC215 with additional details in BC216-BC228.
7 Canadian Institute of Actuaries Educational Note "Accounting Discount Rate Assumption for Pension and Post-employment Benefit Plans" September 2011.

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