

IFRS: What you need to know

Accounting for employee benefits under IFRS

An IFRS publication



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The heart of the matter

**IFRS conversion
will impact the
accounting treatment
of compensation
and benefit plans.**

The International Financial Reporting Standards (IFRS) conversion process is labor intensive, time consuming and may present challenges for large global companies. While many companies may initially think of IFRS as an accounting/reporting matter, they will quickly realize conversion is an enterprise-wide project impacting multiple layers of operations.

Conversion to IFRS will result in a single, worldwide standard for financial reporting. IFRS will enhance comparability and transparency, which will be beneficial to all stakeholders. A single standard should create cost efficiencies for global companies and—with fewer rules and exceptions—help to reduce complexity and the risk of errors. As a result, the move toward convergence is both inevitable and advantageous for US corporations. The timeline included in the SEC roadmap provides for adoption of IFRS in the US between 2014–2016, while early adoption options may be available as early as 2009. The SEC has stated that they will reassess the transition to IFRS in 2011.

The move to IFRS involves a fundamental change in the framework of how US companies measure pre-tax income and the principles governing accounting for income taxes. Therefore, conversion is sure to impact the accounting treatment of the organization's benefits, pensions, stock-based compensation and overall compensation arrangements.

In this paper, we will highlight some of the significant differences between International Accounting Standard (IAS) 19 and US generally accepted accounting principles (US GAAP) for post-employment benefits, including pensions and other post-retirement benefits such as retiree health benefits, and review the proposed changes to IAS 19. The proposed changes will most likely result in significant differences from the way post-employment benefit plans are accounted for currently under either international or US standards.

Accounting for employee benefits under IFRS is governed by IAS 19, *Employee Benefits*. IAS 19 covers all types of employee benefits, other than share-based payments. IAS 19 classifies benefits as short-term, post-employment, other long-term and termination benefits. The discussion in this paper will concentrate primarily on post-employment benefits, which include pensions and other post-retirement benefits such as retiree health benefits. Whereas IFRS has one standard covering all types of employee benefits, US GAAP contains several standards that govern the accounting for similar types of employee benefits.

As the standards currently exist, there are many similarities between IAS 19 and US GAAP. However, there are a number of key differences between the accounting frameworks that may have significant impacts on the income statement and balance sheet upon transition to IFRS. These, in turn, could impact debt covenants, the ability to pay dividends, and employee incentive awards linked to earnings. To understand the potential impact related to benefit arrangements, it is important for companies to inventory their existing employee benefit arrangements, determine appropriate accounting policies and estimate the impact of adopting IFRS.

An in-depth discussion

A review of the differences between IAS 19 and US GAAP for post-employment benefits, which include pensions and other post-retirement benefits such as retiree health benefits, and proposed changes to IAS 19.

US GAAP and IAS 19—differences to consider

The following highlights key policy decisions and some of the more significant differences between IAS 19 and US GAAP for post-employment benefits that will need to be addressed by many US corporations:

- **IFRS 1, First-time adoption of IFRS**—IFRS 1 gives companies the choice to not retrospectively apply IAS 19. If this election is made, the funded status of the post-employment benefit plans, less any unvested prior service cost, will be recognized on the balance sheet at the date of transition to IFRS (i.e., gains and losses accumulated to the date of transition are eliminated). This transition date will be the beginning of the earliest period presented. However, subsequent gains and losses, after the date of transition to IFRS, will be accounted for in accordance with the accounting policy elected.
- **Gain/loss recognition post transition to IFRS**—Gains or losses occur when plan experience differs from that assumed or a company changes its actuarial assumptions. Under both IFRS and US GAAP, a company has an accounting policy that identifies the method it will use to recognize these gains and losses into earnings or equity. IAS 19 and US GAAP allow two similar accounting methods for recognizing gains and losses into earnings. They are often referred to as the (1) “Corridor Method” and the (2) “Faster Recognition Method”. IAS 19 has a third acceptable accounting policy for recognizing gains and losses, often referred to as the “SORIE Method”, for the Statement of Recognized Income and Expense.

Under the Corridor Method, a portion of the gains or losses is recognized in earnings when the cumulative amounts of these gains or losses exceed 10% of the benefit obligation, or assets, if larger (“the corridor”).

Under the Faster Recognition Method, gains or losses are recognized in earnings using any systematic approach that results in faster recognition of gains or losses than the Corridor Method, provided that the company consistently applies the same basis to both gains and losses in all periods presented. The Faster Recognition Method could mean immediate recognition of gains or losses in earnings in the fiscal year in which they occur.

For US GAAP, with the recent adoption of Financial Accounting Standard (FAS) 158, the funded status of the benefit plan is recognized on the balance sheet. Under both the Corridor Method or Faster Recognition Method, US GAAP requires cumulative gains or losses not recognized in earnings to be recognized in equity (in Accumulated Other Comprehensive Income, AOCI) and recycled out of equity in later periods to the extent they are recognized in earnings, based on the methods described above. For IAS 19, the funded status is not required to be recognized on the balance sheet. Rather, IAS 19 permits cumulative gains and losses to remain off balance sheet, subject to disclosure requirements, unless the SORIE Method has been elected.

The SORIE Method, allowed under IAS 19 only, recognizes gains and losses in equity in the fiscal year the gains or losses occur. If a company elects the SORIE Method, the cumulative gains or losses in equity are not subsequently recycled through the income statement as they would be under US GAAP. Note that the SORIE will be referred to as Other Comprehensive Income (OCI) similar to US GAAP, for periods beginning on or after January 1, 2009.

Caution area: Under IAS 19, careful consideration should be given to the accounting policy related to gains and losses as it will impact how and where gains or losses are recognized (equity only or earnings).

The SORIE Method provides less volatility in earnings; however, it may provide significant volatility to the balance sheet and shareholder's equity.

- **Gain/loss amortization period:** If the company is applying the Corridor Method or the Faster Recognition Method (other than immediate recognition), the excess gain or loss outside of the corridor is amortized into earnings over a stated period of time. Under both US GAAP and IAS 19, for benefit plans with on-going benefit accruals, this amortization period is generally equal to the active future working lifetime or any shorter period, if applied consistently.

For plans where all participants entitled to future benefits are no longer actively employed with the company, "inactive benefit plans", the amortization period differs under US GAAP and IAS 19. IAS 19 requires inactive benefit plans to immediately recognize the gains or losses that exceed the corridor. US GAAP requires these plans to recognize the gains or losses that exceed the corridor over the average future lifetime of the participants, although a faster recognition period is allowed if the policy is applied consistently.

Under the Corridor Method or Faster Recognition Method, inactive benefit plans will contribute more volatility to earnings under IAS 19 than under US GAAP.

Caution area: If you sponsor an inactive benefit plan, the Corridor Method or Faster Recognition Method under IAS 19 will require immediate recognition in earnings of gains or losses outside of the corridor.

To illustrate the potential impact of the differences in the gain/loss treatment, consider the following example:

Inactive benefit plan using the corridor method as the accounting policy.

The plan experienced an actuarial loss of \$20 million in the current year. The average future lifetime of inactive participants is 15 years.

Assuming that the cumulative deferred loss in AOCI at the end of the prior year was at the corridor, the charge to the income statement for the current year loss is \$1.3 million (\$20 million/15) under US GAAP but \$20 million under IAS 19.

Under IAS 19, if the company's accounting policy was the SORIE method, the \$20 million loss would be charged to equity rather than the income statement.

- **Plan amendment recognition**—When a company makes a plan change to increase benefits, IAS 19 requires the full impact of the plan change to be reflected in earnings if the employees are vested in the benefit. The impact of the plan change is reflected in the prior service cost component of expense. IAS 19 allows only the non-vested portion of the plan change to be amortized into earnings with the amortization period equal to the remaining vesting period. US GAAP generally requires the entire impact of plan changes to be amortized over a longer period (e.g., based on the future working lifetime or average inactive lifetime) for pension plans. Accordingly, the timing of recognition of plan changes in the income statement could be very different under IAS 19 and US GAAP. Other differences exist with respect to amortization of prior service cost related to postretirement benefits and to the treatment of negative plan amendments under US GAAP and IFRS.

Caution area: Under IAS 19, the entire increase in benefit obligation due to vested benefits is immediately recognized into earnings at the date the amendment is adopted (not effective). The benefit obligation related to non-vested benefits should remain off-balance sheet and be recognized into earnings over the remaining vesting period. Upon transition to IFRS, companies will need to determine what portion, if any, of the existing US GAAP prior service costs are non-vested. These amounts will be off-balance sheet upon initial adoption of IAS 19 and subsequently recognized into earnings. Note that the SORIE Method does not apply to prior service cost.

To illustrate the potential impact of the different treatments for plan amendments on the income statement, consider the following example:

Pension plan is amended to provide higher benefits, resulting in a \$20 million increase in the benefit obligation. All participants are vested in the benefit. The average future working lifetime is 10 years.

Based on the above facts, the current year charge to the income statement for the plan change is \$2 million (with a like amount charged each year for 10 years) under US GAAP; but \$20 million (all in the current year) under IAS 19.

• **Special event accounting**—A number of events trigger special accounting for employee benefit plans. These events range from eliminating future benefit accruals for all or a portion of the covered population to settling the benefit obligation through the purchase of third party insurance products or cash settlement. In most situations, there are three key differences to consider:

1. “Triggering event”—Some special events under US GAAP (i.e., curtailments and settlements) will not be accounted for as special events under IAS 19 and vice versa.
2. The magnitude of the gain or loss recognized in earnings may be different.
3. The timing of the recognition may be different.

See the appendix for additional details on these differences.

Caution area: If you have, or are considering having a significant event such as a reduction in workforce or elimination of future benefit accruals, note that the method used to measure the impact of the significant event, as well as the timing for recognizing gains due to the event, differs between US GAAP and IAS 19. For example, where a curtailment results in a gain, under IFRS the gain will be recognized in earnings when the curtailment occurs, not when the employees terminate as under US GAAP. Under IAS 19, a curtailment is deemed to occur when a plan amendment is contractually binding or an entity is demonstrably committed to a reduction in force.

- **Valuation of obligation**—Both standards require the benefit obligation to reflect the terms and conditions of the underlying benefit plans at the measurement date. IAS 19 requires any obligations arising from an employer’s informal practice, including implicit promises for future increases in benefits not currently included in the explicit plan terms, to be explicitly valued in the benefit obligation. In contrast, US GAAP allows the obligation to be limited to the increases covered under the existing written or substantive plan or union contracts.

Therefore, companies with a history of granting pension increases may need to reflect this pattern in their IAS 19 benefit obligation. For example, consider a collectively bargained plan that bases its benefit promise on a stated benefit multiplier per year of service (referred to as a flat dollar benefit plan). If a company has an established pattern of providing an annual \$1 increase in the benefit multiplier, the company may be required to reflect an ongoing \$1 increase for all future years in its defined benefit obligation under IAS 19, unless sufficient evidence exists that this level of increase will not continue. This could result in a significant increase in the benefit obligation for many flat dollar benefit plans that have a history of increasing the benefit multiplier.

- **Selection of a discount rate**—To determine the appropriate discount rate to value the benefit obligation, both standards call for the use of current yields on high quality corporate bonds based on the country in whose currency the benefit will be paid. In countries where no deep corporate bond market exists, IAS 19 requires the use of government bond yields. US GAAP does not specifically address situations where there is no deep corporate bond market but general practice has been to apply a discount rate that reflects government bond yields plus a spread for credit risk.

Caution area: If you have defined benefit plans in countries with no deep corporate bond market, IAS 19 will result in a lower discount rate and a higher benefit obligation than may be the case under US GAAP, if you currently apply a credit spread when setting your discount rate.

- **Geography of net periodic benefit cost in income statement**—The net periodic benefit cost contains up to five different components (excluding special event charges); (1) service cost, (2) interest cost, (3) expected return on assets, (4) amortization of prior service cost, and (5) amortization of gain/loss. US GAAP requires the entire benefit cost associated with postretirement benefit plans to be recognized as a single component in earnings. This benefit cost is typically included in the operating expenses of a company. IAS 19 does not require the single component presentation. Companies can elect, for example, to recognize certain components of benefit cost as an operating expense and to recognize the finance-related components of benefit cost in finance costs (i.e., interest and expected return on assets).

International Accounting Standards Board (IASB) Project—proposed changes to IAS 19

The IASB has initiated a project related to IAS 19 to identify issues some believe impair the clarity and reliability of financial statements. If these changes are made, this would fundamentally change how many benefit plans are valued and recognized on a company's financial statements. The IASB has recently agreed to issue an exposure draft covering defined benefit plan recognition and presentation, including disclosure requirements. The main items to be addressed in the exposure draft are expected to be as follows:

1. Potential elimination of the Corridor Method and SORIE Method for recognizing gains or losses. All increases or decreases to defined benefit obligations and the fair value of plan assets resulting from gains or losses would be immediately recognized in the income statement under the current proposal.

2. Potential elimination of amortization of the non-vested portion related to plan amendments. All increases or decreases to defined benefit obligations resulting from plan changes would be immediately recognized in the income statement under the current proposal.
3. Potential elimination of the choice related to the geography of the net periodic pension cost in the income statement. IAS 19 may require disaggregation of benefit costs into operating, financing and remeasurement components and may specify how to measure each component and where to report it on the income statement.

The IASB is expected to issue an exposure draft of these proposed changes in 2010, and a final amendment to the standard in 2011. The IASB timetable calls for the new guidance to be effective in 2013.

In addition to the above, the IASB is considering drafting a second exposure draft that would develop a new category of benefit promises referred to as Contribution-Based Promises (CBPs). CBPs would generally include obligations for non-traditional or hybrid benefit promises that include elements of defined benefit and defined contribution plans (e.g., US cash balance plans, career average plans, guaranteed defined contribution plans, etc.).

What this means for your business

Understanding how these differences may impact your company's benefit plans, income statements, balance sheets and key performance indicators.

What companies should do now

Companies should start to identify the key differences between US GAAP and IFRS and understand the required accounting under IAS 19, including the potential changes to the accounting related to benefit plans that would result under the new IFRS rules that may potentially go into effect in 2013. This will enable them to gain an understanding of how these differences will impact the accounting for their plans, and if any differences would significantly affect their income statements, balance sheets, and key performance indicators.

As a good first step, companies should complete a global inventory of their benefit plans, and determine how IAS 19 will impact each plan. To accomplish this goal, finance and tax resources will need to work with the human resources group on a multi-phase action plan.

Some suggested action steps are as follows:

- Document the key differences between US GAAP and IFRS affecting pension and other post-retirement benefit plans.
- Estimate the impact of each key difference on the balance sheet and income statement, considering the alternative policy elections available under IAS 19.
- Consider the timing of adoption in relation to the new guidance expected to be effective under IFRS in 2013 and how this new guidance may impact the transition to IFRS.
- Assess whether adoption of new IFRS accounting may warrant a change to your benefit plans and other compensation programs, and/or the investment strategy for your plans.
- Evaluate whether any IFRS accounting changes will require you to modify your record-keeping and administrative systems.

Appendix

Key considerations of differences related to special event accounting under IAS 19 and US GAAP.

Does the special event trigger special event accounting?

Triggering events under US GAAP and IAS 19

Theme	US GAAP	IFRS
Definition of a curtailment	An event that significantly reduces the expected years of future service of present employees or eliminates for a significant number of employees the accrual of defined benefits for some or all of their future service.	An event that demonstrably commits an entity to make a material reduction in the number of employees covered by a plan or amends the terms of a defined benefit plan such that a material element of future service by current employees will no longer qualify for benefits or will qualify only for reduced benefits.
Quantitative threshold for curtailment	Reduction in future years of service must be “significant.” Generally, 5–10 percent reduction is considered significant.	Impact must be material in relation to overall financial statements.
Quantitative threshold for settlement	Settlement accounting not required if total settlements are less than interest cost plus service cost.	No bright line test exists.
Treatment of single sum distributions as settlements	Single sum distributions of the entire benefit are considered settlements subject to the service cost plus interest cost threshold.	Single sum payouts that are paid in the normal course are generally not considered settlements.

Magnitude of gain or loss recognition in earnings

Theme	US GAAP	IFRS
Determination of the magnitude of the curtailment (gain) loss	Comprised of two elements: (1) prior service costs associated with years of service no longer expected to be rendered, and (2) change in benefit obligation net of gains or losses in AOCI.	A related portion of both the existing prior service costs and the existing gains or losses plus any change in obligation or assets. Note: Under SORIE Method, no portion of existing gains or losses are recognized due to curtailment.

Timing of recognition

Theme	US GAAP	IFRS
Timing of the recognition of the curtailment (gain) loss	Different timing depending on whether the curtailment results in a gain or loss. Curtailment losses are recognized at the time that the effects are probable and estimable. Curtailment gains are recognized when the plan is amended or the participants are severed.	Same timing whether the curtailment results in a gain or a loss. Curtailment gains and losses are recognized when the plan amendments are contractually binding or when an entity is demonstrably committed to a reduction in force.

Contacts

The white paper is intended not just to inform but to raise questions. Clients of PricewaterhouseCoopers may want to open a dialogue about IFRS with their PwC engagement partner or the primary authors of this paper who welcome any questions about the accounting, HR, and tax implications of IFRS:

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