

# Employee benefits: significant changes proposed by the International Accounting Standards Board

Accounting for defined benefits plans is complex and gives rise to large and highly uncertain costs for many companies.

Many companies in particular account for pension obligations using the so-called 'corridor mechanism'. This mechanism allows much of the large and volatile changes in pension fund values not to be recognised.

On 29 April 2010, the IASB published an exposure draft to address this issue: it has proposed major changes in accounting for long-term employee benefits such as pensions. The most significant proposal is the removal of the 'corridor mechanism'. In addition to this, there are a number of other changes, the most significant of which are discussed below.

## 'Corridor mechanism' to be abolished

The 'corridor mechanism' will be removed. This means all changes in the value of long-term employee benefit plans will be recognised as they occur. Those movements are recorded in profit and loss and other comprehensive income as follows:

- ▶ Profit and loss will be charged with a service cost and a finance cost or credit. The finance cost or credit is the product of the net balance sheet liability or asset and the discount rate used to measure the obligation.
- ▶ 'Remeasurements' will be recorded in other comprehensive income. These are all other movements in the balance sheet amount (essentially these are currently described as actuarial gains and losses). This removes the concept of expected returns on plan assets.

The current option to recognise all movements in profit and loss is to be withdrawn.

Settlement gains or losses are considered to be actuarial variances and, as such, are remeasurements. Therefore, settlements will be recorded in other comprehensive income rather than in income, as at present.

## Other recognition and measurement changes

Further guidance has been proposed on the treatment of costs of administering benefit plans and taxes payable by the benefit plans.

The distinction, for accounting purposes, between post-employment benefits and other long-term benefits is to be removed.

This means actuarial variances on all long-term benefits will be recorded in other comprehensive income. An example would be a bonus granted subject only to continuing employee service for three years. Throughout the three years of service remuneration expense is recognised on the basis of the entity's expectations about forfeiture. If during year 2, more employees leave the entity than expected, service cost and accrual of interest is still recognised in profit and loss up to the date the employees leave, with a subsequent actuarial gain recognised in other comprehensive income as a change in actuarial assumption.

The distinction between long-term and short-term benefits will be changed to be based on when an employee is expected to receive the benefit rather than when the employee becomes entitled to it. For example:

If paid holiday may be taken at any time, but is expected to be rolled-up for a number of years and taken as a sabbatical, it would be accounted for as a long-term benefit. Accordingly, the projected unit credit method (as used for pensions) would be applied, with actuarial variances recorded in other comprehensive income.

When a plan is amended, all related unvested past service costs must be recognised immediately, rather than amortised over the vesting period.

## Disclosure

Some further disclosure requirements are proposed, including more information about:

- ▶ The characteristics of employee benefit plans
- ▶ The risks arising from employee benefit plans, including sensitivity analyses
- ▶ Multi-employer plans

## Business impact

The removal of the corridor will introduce a great deal more volatility in net assets, with potential consequences for debt covenant ratios and other target ratios.

For companies currently recognising actuarial variances in full within other comprehensive income, the change in presentation of periodic movements in balance sheet values may lead to a reduction in profits. This is because profit and loss is currently credited with an expected return on assets based on their expected long-term yield which is typically considerably higher than the discount rate used to discount the obligation.

To comply with the proposals, little new data needs to be collected, so we see little impact on data systems with the exception, perhaps, of those entities affected by the new requirements for distinguishing short-term and long-term employee benefits.

The IASB has requested comments by 6 September 2010.

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