EFRAG

European Financial Reporting Advisory Group

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Director General
European Commission
Directorate General for the Internal Market
1049 Brussels

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Dear Mr Faull

Adoption of IAS 19 *Employee Benefits* (as amended in June 2011)

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of IAS 19 Employee benefits (as amended in June), which was issued by the IASB on 16 June 2011. It was issued as two Exposure Drafts in June 2005 and April 2010 and EFRAG commented on those drafts.

The standard sets out to help users of financial statements better to understand how defined benefit plans affect an entity's financial position, financial performance and cash flows. The objective of the standard is to prescribe the accounting and disclosure for employee benefits.

The main changes introduced by the amendments to the standard are:

- Elimination of the corridor approach, which results in immediate recognition of changes in the estimation of the defined benefit obligation and in the fair value of the plan assets.
- Recognition of unvested plan costs in the year when an amendment to the plan is made.
- Disaggregation of the plan costs into three components: service costs, finance costs and remeasurement. Service and finance costs should be recognised in profit and loss. Remeasurements should be recognised in other comprehensive income. Changes in the estimate of service costs and in demographic assumptions should be included in the remeasurement component.
- The new standard proposes that the finance cost component comprises net interest income or expense, determined by applying the high quality corporate bond rate to the net defined asset or liability. As a consequence, it eliminates the requirement in IAS 19 to present an expected rate of return in profit or loss.
- Treatment of plan amendments, termination benefits, curtailments and settlements.
- Disclosure objectives and new proposed disclosures.

- Other amendments, like, for example, the consideration of risk-sharing, and conditional indexation in the estimation of the defined benefit liability.

The standard becomes effective for annual periods beginning on or after 1 January 2013. Earlier application is permitted, however entities shall disclose that fact.

EFRAG has carried out an evaluation of the Amendments. As part of that process, EFRAG issued an initial assessment for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.

EFRAG supports the Amendments and has concluded that they meet the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that they:

- are not contrary to the 'true and fair view' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

- meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

For the reasons given above, EFRAG believes that it is in the European interest to adopt the Amendments and, accordingly, EFRAG recommends their adoption. EFRAG's reasoning is explained in the attached 'Appendix – Basis for Conclusions'.

On behalf of the members of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely

Françoise Flores
EFRAG, Chairman

APPENDIX
BASIS FOR CONCLUSIONS

EFRAG'S TECHNICAL ASSESSMENT OF THE AMENDMENT AGAINST THE ENDORSEMENT CRITERIA

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on the Amendments to IAS 19 Employee Benefits (as amended in June 2011).

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity of contributing to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity of advising the European Commission on endorsement of the definitive IFRS in the European Union and European Economic Area.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the technical criteria for the European endorsement, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

Does the accounting that results from the application of the IAS 19 *Employee Benefits* (as amended in June 2011) meet the technical criteria for EU endorsement?

1 EFRAG has considered whether the IAS 19 *Employee Benefits* (as amended in June 2011) meets the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002, in other words that the IAS 19 *Employee Benefits* (as amended in June 2011):

   (a) Is not contrary to the principle of 'true and fair view' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

   (b) meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

   EFRAG also considered, based only on evidence brought to its attention by constituents, whether it would be not conducive to the European public good to adopt the IAS 19 *Employee Benefits* (as amended in June 2011).

Approach adopted for the technical evaluation of the IAS 19 Employee Benefits (as amended in June 2011)

2 The Amendments to IAS 19 *Employee Benefits* mainly introduce changes to the recognition, presentation and disclosure requirements for defined benefit plans. The Amendments to IAS 19, as described in Appendix 1, have been assessed in the following five groups, based on their nature and impact:

Group A: Amendments related to presentation and disclosures

- Disaggregation of defined benefit cost components.
- Disclosures.

Group B: Amendments related to recognition and measurement of the liability

- Immediate recognition of all changes in the net liability or asset. Elimination of the 'corridor approach' and elimination of options in the presentation of actuarial gains and losses. Requirement to present the remeasurements component in other comprehensive income and hence elimination of options in the presentation of actuarial gains and losses.
- Presentation of the service cost and net interest income (expense) in profit or loss.

Group C: Measurement of the pension cost recognised in profit and loss

- Redefining the components of defined benefit cost – Determining the net interest cost.

Group D: Amendments related to significant changes in the conditions or extinguishment of the benefit or employment relationship

- Treatment of plan amendments, curtailments and settlements.
- Recognition of termination benefits.

Group E: Transitional provisions

3 EFRAG notes that, the remaining Amendments listed below are clarifications or corrections. EFRAG believes these Amendments will make the standard easier to implement consistently, without having other impacts. Those Amendments, which are not discussed specifically in this Appendix, are related to:

- Multiemployer plans.
- Other long-term and short-term benefits.
- Risk-sharing programmes, conditional indexation, taxes and administration costs.
- Measurement of termination benefits.
- Entities that participate in state plans or defined benefit plans that share risks between various entities under common control.
- Mortality assumptions.

Group A: Amendments related to presentation and disclosures

- Disaggregation of defined benefit cost components.
- Disclosures.

Relevance

4 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations.

5 EFRAG considered whether the Amendments in Group A would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

6 Under the new requirements, the change in the net defined benefit liability (asset) is disaggregated into a service cost, a net interest and a remeasurements component. This approach is similar to the previous disaggregation but replaces the expected return on assets and the interest cost on the defined benefit obligation with a single net interest component. The new approach treats the net defined liability (asset) similar to a receivable or payable as it is considered equivalent to an amount owed to or from the plan. As a consequence of this new approach, a deficit will result in interest expense and a surplus in interest income, reflecting the financing element of the amount owed to or from the plan. Previously, a deficit could result in net finance income if the expected return on plan assets exceeded the interest cost on the defined benefit obligation. In addition, the distinction between service cost, net interest and remeasurements makes it possible to distinguish the effect of facts related with the performance by the employees (service cost) from the effects due to the time and from changes in the components that represent the period-to-period fluctuations in the long-term value of the defined benefit obligation and plan assets. Therefore, the disaggregation is consistent with the accounting model of IAS 19 and provides more useful information to users.

7 That disaggregation is also reflected in the amended disclosures provisions when requiring certain reconciliations to explain the amounts in an entity's financial statements arising from its defined benefit plans. Those amended disclosures also require additional information about the exposure to risk and information about the asset-liability matching strategies. That information provides an insight into an entity's future cash flow needs and the cash flows available to an entity from the amount owed from the plan. The proposed disclosures also highlight the risks arising from the pension plans and the matching strategies of the company. Thus information resulting from the Amendments in Group A will be relevant for the users of financial statements.

8 EFRAG's overall assessment is that the Amendments in Group A would result in the provision of relevant information; and therefore they satisfy the relevance criterion.

Reliability

9 EFRAG also considered the reliability of the information that will be provided by applying the Amendments in Group A. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to

represent faithfully what it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

10 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness. In EFRAG's view, the Amendments in Group A do not raise any significant issues concerning reliability.

11 EFRAG notes that the disaggregation requires information consistent with the accounting model of IAS 19. Also this information would likely be closely related to an entity's internal reporting. Additionally, in managing its risk-exposures, an entity would most likely already monitor the information required by the amended disclosures. Furthermore, the disclosure requirements are of a similar nature to those already required by IFRS 7 *Financial Instruments: Disclosures* and IAS 39 *Financial Instruments: Recognition and Disclosure*.

12 For the reasons stated above, EFRAG's overall assessment is that the Amendments in Group A satisfy the reliability criterion.

Comparability

13 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

14 EFRAG has considered whether the Amendments in Group A result in transactions that are:

   (a) economically similar being accounted for differently; or

   (b) transactions which are economically different being accounted for as if they were similar.

15 Although the Board has finally decided not to specify where in profit or loss an entity should present the service cost and finance cost components (presentation should be within the boundaries of IAS 1 *Presentation of Financial Statements*, in the way that is most relevant to the entity), the Amendments reduce the areas where there could be a choice. Therefore EFRAG believes that the Amendments result in similar plans and defined benefit costs being disclosed and disaggregated in a comparable manner.

Group B: Amendments related to recognition and measurement of the liability

- Immediate recognition of all changes in the net liability or asset. Elimination of the 'corridor approach' and elimination of options in the presentation of actuarial gains and losses. Recognition of the remeasurements component in other comprehensive income.

- Presentation of the service cost and net interest income (expense) in profit or loss.

Relevance and Reliability

16 The recognition of the remeasurements component in other comprehensive income acknowledges the fact that the underlying reasons and causes of period-to-period fluctuations in the long-term value of the defined benefit obligation and plan assets

in long-term value are different in nature from the factors that cause changes in the other components of pension costs. If such changes in non-recurring components are recognised in profit and loss of an entity that may be unhelpful for users of financial statements in assessing performance on its operational activities. That makes relevant such recognition in other comprehensive income. Apart from this point, the relevance and reliability of information are not significantly affected by the Amendments in Group B.

Comparability

17 The Amendments in Group B address existing divergent practice in respect of recognising the actuarial gains and losses arising from defined benefit plans through the removal of the options previously contained in IAS 19. The previous options allowed entities with three options for the recognition of actuarial gains and losses: immediate recognition in profit or loss or in other comprehensive income, or deferred recognition for actuarial gains and losses outside the corridor through profit or loss with unrecognised actuarial gains and losses that were within the corridor. The Amendments in Group B require entities to recognise all the changes in the period in which those changes occur through other comprehensive income. This will bring consistency in accounting for the actuarial gains and losses, now included in the remeasurements component, and therefore will increase comparability between entities. Therefore, EFRAG's overall assessment is that the Amendments in Group B satisfy the comparability criterion.

Group C: Measurement of the pension cost recognised in profit and loss

- Redefining the components of defined benefit cost – Determining the net interest cost.

Relevance

18 For similar reasons for those explained for Group A, EFRAG's overall assessment is that the Amendments in Group C would satisfy the relevance criterion as the Amendments focus the attention on the time value. The net interest component will provide information regarding the financing effect of the net defined liability (asset). Entities with deficits will recognise accordingly an interest expense in profit or loss. Otherwise, entities will recognise interest income, reflecting the financing element of the amount owed to or from the plan in both situations.

Reliability

19 EFRAG notes that the objective of the net interest approach is to provide more understandable information of the economic cost (or benefit) of a defined benefit liability (asset) than would be the case if finance income and expenses were to be determined separately on the plan assets and the defined benefit obligation using different discounting rates for each of those. Under the net interest approach the entity discounts the economic benefits that it expects to receive from the plan or from the employees in the form of reductions in future contributions or as refunds using the same rate as for the defined benefit liability, i.e., a discount rate determined by reference to market yields on high quality corporate bonds (or government bonds if a deep market does not exist). This discount rate can be determined in a more objective way and might not include a return that is not simply attributable to the passage of time when compared to the expected return on plan assets as previously used. However, EFRAG continues to believe that entities would benefit from guidance on estimating a market yield and, in particular,

guidance that resolves the issues that arise if there is not a deep market for high quality corporate bonds in an entity's jurisdiction.

20 The expected return approach reflects the expected performance of the assets by the management and not the actual performance. The net interest approach results in recognition of interest income when the plan has a surplus (and interest cost when the plan has a deficit), while the difference between the expected and actual performance on plan assets is recognised in other comprehensive income. This avoids the reliability concern that would have arisen if an entity were to be required to separate the change in the fair value of plan assets between a net interest and an investing component. For the reasons above, EFRAG's overall assessment is that the net interest approach satisfies the reliability criterion.

Comparability

21 As indicated, the Amendments require entities to calculate net interest on the net defined benefit liability (asset) using the same discount rate used to measure the defined benefit obligation. Entities applying the same discount rate to their liabilities, will determine consistently their financing cost (benefit). This approach will result in greater consistency between entities and removes the subjectivity involved in determining the expected return on assets.

22 For the reasons stated above, EFRAG's overall assessment is that Group C of Amendments satisfies the comparability criterion.

Group D: Amendments related to the significant changes in the conditions or extinguishment of the benefit or employment relationship

- Treatment of plan amendments, curtailments and settlements.

- Recognition of termination benefits.

Relevance

23 As explained in Appendix 1, the Amendments require immediate recognition of all past service costs. Recognising unvested past service costs immediately is consistent with the recognition of unvested current service costs that IAS 19 treats as an obligation (for example, paragraph 44 of IAS 19). Although EFRAG believes that this recognition is inconsistent with IFRS 2, it believes that internal consistency within IAS 19 (2011) is preferable. In addition, recognition of unvested past service costs over the vesting period gives rise to concerns about the potential for accounting arbitrage.

24 EFRAG expects that the level of information provided to users of financial statements under the new Amendments will be similar to that presented under the previous requirements for plan amendments, curtailments, settlements and termination benefits. IAS 1 requires disclosure of employee benefits expense. Furthermore, when items of expense are material, that standard requires an entity to disclose their nature and amount separately. As a result, the relevance of information will not be affected by the Amendments included in group D.

Reliability

25 Before these Amendments, an entity recognised curtailments resulting from a significant reduction in the number of employees covered by the plan when it was demonstrably committed to making the reduction. The Amendments require an entity to recognise termination benefits at the earlier of when it can no longer withdraw an offer and when it recognises costs of a restructuring that also includes termination benefits. Thus the changes reduce the need for the exercise of judgement by removing the "demonstrably committed" criteria; an area still requiring judgement is when a restructuring takes place, but this is the same as the existing criteria under IAS37.

26 For the above reasons EFRAG's overall assessment is that the Amendments in Group D satisfy the reliability criterion.

Comparability

27 Entities will have to recognise the effects of plan amendments, curtailments and settlements in profit or loss as part of the service cost component. As a consequence of this change, their definitions have been reviewed. Sometimes there is an overlap between the definitions of settlements, curtailments and plan amendments and the transactions usually happen at the same time, so it can be difficult to allocate the gains and losses between them. In other cases it is difficult to distinguish their effects. To introduce a single accounting treatment for these types of transactions when they occur at the same time reduces practical difficulties and diversity in practice.

28 The above changes will improve consistency in accounting and therefore will increase comparability between entities. Therefore, EFRAG's assessment is that the Amendments in Group D satisfy the comparability criterion.

Group E: Transitional provisions

Relevance, reliability and comparability

29 EFRAG believes that retrospective application is generally preferable where practicable. IAS 19 (2011) requires full retrospective application with two minor exceptions regarding capitalised employee benefit costs and disclosures about sensitivity. The impact on the relevance of the financial information of these exceptions is insignificant in both cases. Also, the exception regarding disclosures provides for the staged introduction of the underlying disclosures and only affects financial statements in the first two years of application of the standard, but not thereafter.

30 Initial application of the new requirements in IAS 19 (2011) may require entities to reconstruct or recalculate certain information (e.g. tax impact on the employee benefit obligation), which may raise concerns about the reliability and comparability of the information. However, EFRAG believes that IAS 19 (2011) does not require significant new information over and above that which is already available to entities currently applying IAS 19.

31 Therefore, the transitional provisions do not give rise to any significant concerns about the relevance, reliability and comparability of the information produced under IAS 19 (2011).

Amendments A, B, C, D and E

Understandability

32 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence.

33 Although there are a number of aspects to the notion of 'understandability', EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability. For example, information that represents something as similar when it is in fact dissimilar is not comparable, and that lack of comparability will mean it is also not understandable, and vice versa.

34 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of the Amendments is understandable, is whether that information will be unduly complex.

35 EFRAG notes that the Amendments do not involve new concepts or notions other than those used hitherto. The Amendments themselves do not introduce any new complexities that may impair understandability. The overall objective of the Amendments is to ensure that financial statements provide users with a clear picture of an entity's commitments resulting from defined benefit plans.

36 In EFRAG's view, the Amendments do not introduce any new complexities that may impair understandability. Therefore, EFRAG's assessment is that the Amendments satisfy the understandability criterion.

True and Fair

37 EFRAG has concluded that the information resulting from the application of the IAS 19 (as amended in June 2011) would not be contrary to the true and fair view principle.

European public good

38 EFRAG is not aware of any reason to believe that it is not conducive to the European public good to adopt IAS 19 (as amended in June 2011).

Conclusion

39 For the reasons set out above, EFRAG's has decided that the IAS 19 (as amended in June 2011) satisfies the technical criteria for EU endorsement and EFRAG should therefore recommend its endorsement.

DISSENTING OPINION OF NICKLAS GRIP

1 Nicklas Grip (EFRAG TEG member) dissents from recommending endorsement of IAS 19 (2011). This is because Nicklas Grip believes there are concerns with the revised IAS 19, and specifically it:

(a) Introduces a new difference in pension costs between different defined benefit solutions as well as between defined benefit and defined contribution pension schemes.

(b) Exaggerates the difference in size of pension liability and the size of the pension cost between entities having pension liabilities in markets with or without a liquid corporate bond market.

(c) Is implemented at a time when the accounting for life insurance liabilities is heavily debated including measurement and presentation as well as the choice of discount rate. Nicklas Grip considers pension costs and life insurance liabilities to be highly related to each other and they should be considered in parallel, not in isolation, which further questions the relevance of endorsing the revised IAS 19 before deciding on the endorsement of a revised standard for insurance contracts.

2 Nicklas Grip shares the view of the Board that the current standard IAS 19 *Employee Benefits* is complex. However, Nicklas Grip believes that a comprehensive and fundamental review of the entire standard should be made instead of the piecemeal changes now suggested. When that comprehensive and fundamental review is made, conclusions drawn in the insurance projects should be considered due to the similarities between the two standards.

Introduces a new difference in pension costs between different defined benefit solutions as well as between defined benefit and defined contribution pension schemes

3 Nicklas Grip considers that a problem with the standard is the differences in measurement models between defined benefit and contribution pension schemes. Nicklas Grip is concerned that the Board's proposal exaggerates rather than removes these differences.

4 Nicklas Grip argues that the pension costs, presently, have the same items recognised in profit or loss when companies choose the option of recognising all gains and losses in profit or loss immediately, regardless of if the pension scheme is funded or not and regardless if the plan is classified as defined contribution or defined benefit. For entities currently using the corridor approach, the amounts recognised in profit or loss would similarly become equal when considering the overall effect over time. This would only therefore not be the case for entities that currently recognise actuarial gains and losses in other comprehensive income. The items are service costs, interest and returns on assets supporting the liabilities. In the premiums to the life insurance company these items are netted when the insurance company calculates its premiums, in the unfunded plan, the return on the assets is presented with other similar assets and not directly in connection to the pension costs and finally, for funded pension schemes, this information is presented gross as disclosures.

5 By introducing the interest on the net asset/liability this consistent principle for what is recognised in profit or loss has been removed and Nicklas Grip fails to see this as

an improvement of IAS 19 and fails to see the logic in presenting a return being equal regardless of the investment strategy.

Exaggerates the difference in size of pension liability and the size of the pension cost between entities having pension liabilities in markets with or without a liquid corporate bond market

6 Nicklas Grip also believes that a revision of the standard should have included a revised guidance on determination of the rate for discounting pension obligations and a review of the current requirement to link benefits to future salary increases.

7 Nicklas Grip believes that it is essential that amendments in the measurement model for defined benefit plans do not further deteriorate users' ability to make a durable estimate of the pension impact on the comprehensive income. As pension plans are long-term in nature it is necessary to have some kind of allocation mechanism for actuarial gains and losses on both obligations and plan assets. In the view of Nicklas Grip, the current corridor method has been a practical way to achieve such allocation. Since the 10% rule is arbitrary, if at all amending IAS 19, the Board should have considered to keep the basic principles of the current allocation mechanism, but abandoned the corridor. This would have functioned as one "adjusted amortised cost methodology" which could have been considered as an alternative also in the insurance project; being an alternative between constant and current discount rates, reflecting the long term nature of pension liabilities. Nicklas Grip believes that the IASC may have had good arguments for the present deferral methodologies used since the present and the revised IAS 19 uses an inconsistent modeling technique (for defined benefit schemes) by comparing the current value of an asset portfolio with current value of future obligations.

8 Furthermore, Nicklas Grip fails to understand the logic in the thinking of the Board when replacing expected return on plan assets with the discount rate of the liabilities. The Board argues that the use of the discount rate best reflects the net liability/asset, but at the same time several new disclosures are implemented that focuses on the actual assets of the funded pension plan, i.e. a gross perspective. Keeping the expected return, in the view of Nicklas Grip, would have been a better reflection of the actual investments and the long-term economics of the plan. To use the same discount rate for both assets and liabilities as decided by the IASB is highly arbitrary and result in a systematic miscalculation of the actual pension cost. Nicklas Grip understands that the determination of the expected yield requires management judgment and may encourage abuse. However, management judgment is crucial to other accounting estimates and assumptions.

9 With regard to the discount rate it is important to consider that there are several countries in the world that do not have deep markets in high quality corporate bonds. In such circumstances, the present, and the revised, standard requires entities to use government bond rates when determining their pension obligation. Nicklas Grip strongly believes that there is a need to review the issue of determination of discount rate in order to create a level playing field between countries that have deep markets in corporate bonds and those that do not. As now revised, countries without a liquid corporate bond market where the interest rates for corporate bonds are higher than corresponding government bond rates will:

   (a) Have higher pension liabilities (i.e. higher deficit or less positive net value), and therefore also,

   (b) Have higher pension costs by the fact that the interest expense/interest income will be calculated based on a higher liability or lower asset and the

lower net asset/higher liability will also be negatively affected by the use of a lower interest rate.

10 As a final remark, Nicklas Grip also questions the relevance of remeasuring plan assets. Plan assets may consist of equity instruments, interest bearing instruments, or perhaps real estate that may be measured at cost or amortised cost according to other IFRSs. It is not obvious to Nicklas Grip why the treatment of those assets should be different depending on whether they are held by a pension trust, directly owned by the entity in an unfunded defined benefit solution, or owned by a life insurance company in a defined contribution scheme.

11 The same point could be made as regards pension obligations. Those liabilities are long term and there is normally no trading intent. The basic measurement basis for liabilities outside of IAS 19 is normally amortised cost. Therefore, Nicklas Grip questions why changes in estimates should be recognised immediately instead of been amortised during the remaining time of service (e.g. compare with IAS 8, p36-38).