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Amendments to AASB 119 – Employee Benefits
The implications for employers

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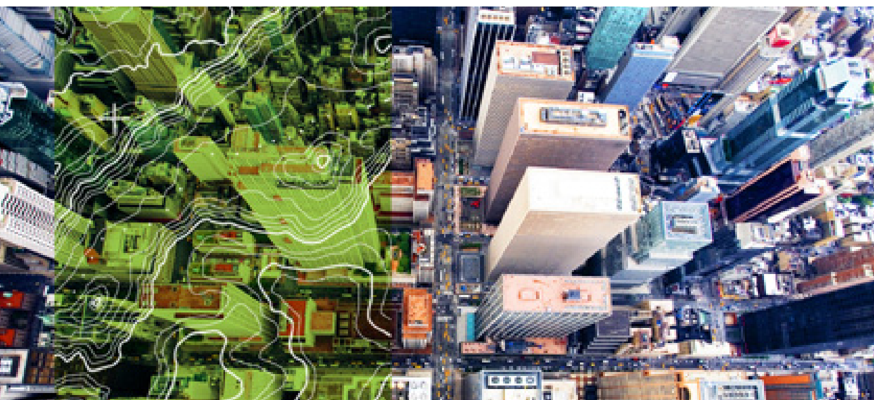


Implementation of the revised AASB 119 is likely to increase the call for a reassessment of whether Australia has a deep, high-quality corporate bond market

On 16 June 2011, the International Accounting Standards Board (IASB) published a revised version of IAS 19 Employee Benefits.

The same changes were reflected by the Australian Accounting Standards Board (AASB) in the revised version of AASB 119 Employee Benefits, issued on 5 September 2011, replacing the superseded requirements of AASB 119 (December 2004, as amended)

Australian Accounting Standard AASB 119 – Employee Benefits

The objective of AASB 119 is to prescribe the accounting and disclosure for employee benefits by employers. The standard identifies four categories of employee benefits with distinct requirements for each of:

- Short-term employee benefits
- Post-employment benefits
- Other long-term employee benefits and
- Termination benefits.

In this paper, we describe the changes made by the revised AASB 119 to the requirements of the superseded standard, starting with a generic description. The most important changes made by the revised AASB 119 and the potential impacts for Australian employers are then discussed in more detail. We also include some questions following the Brief Summary of Changes section that employers should consider now regarding the application of AASB 119 in their organisation.

The revisions to AASB 119 are expected to have the most impact on employers in relation to the measurement of annual leave liabilities in respect of employees, as well as for the measurement and recognition of defined benefit superannuation obligations in the case of those employers who provide defined benefit superannuation to their employees (including former employees, where applicable).

Brief summary of changes

AASB 119 (September 2011) is applicable for reporting periods starting on or after 1 January 2013 (unless adopted early). The most significant changes required on application of the standard are highlighted below

Full recognition of deficit (surplus) on the balance sheet

Under the superseded AASB 119, some of the effect of actuarial gains and losses can be excluded from the net defined benefit liability (asset) by using the 'corridor approach', and the effect of unvested past service costs is recognised over the average vesting period. The revised AASB 119 requires all such items to be recognised immediately:

- Actuarial gains and losses to be recognised in other comprehensive income (OCI) for retirement benefits
- Actuarial gains and losses to be recognised in profit or loss for other long-term employee benefits and
- Past service cost to be recognised in profit or loss within service cost.

Therefore, the net defined benefit liability (asset) recognised on the balance sheet will equal the actual deficit (surplus) in an entity's defined benefit plan.

Few Australian entities currently use the 'corridor approach' for recognising actuarial gains or losses – the ones who do tend to do so for consistency with U.S. GAAP reporting, typically where they have a U.S. parent. This means that most companies in Australia already fully recognise actuarial gains or losses either through OCI (i.e. below the net profit line) or through their profit and loss statement. Therefore, the change to require immediate recognition through OCI is not expected to affect most Australian entities' balance sheets.

Introduction of net interest on the net defined benefit liability (asset)

Under the superseded AASB 119, the expected return on plan assets recognised in profit or loss is determined based on the expected rate of return on investments over the entire life of the underlying obligation. Under the revised AASB 119, the net interest income is introduced as the equivalent of the expected return on plan assets under the superseded AASB 119. The net interest income is included in the net interest on the defined benefit liability (asset), which is the counterpart under the superseded AASB 119 of the interest cost and the expected return on plan assets.

The expected return under the superseded AASB 119 depends on the actual investment portfolio and is typically not equal to the discount rate applied for the determination of scheme liabilities. The net interest income under the revised AASB 119 is determined based on the discount rate applied to liabilities rather than the expected rate of return on assets. When the discount rate is lower than the expected return, application of the revised AASB 119 will increase the defined benefit cost recognised in profit or loss. The difference between the (expected) net interest income and the actual return is recognised in OCI.

The impact of this amendment will be more significant for Australian entities which currently use the government bond rate for the measurement of liabilities under AASB 119 rather than the high quality corporate bond rate which is used in most other jurisdictions. Implementation of the revised AASB 119 is therefore likely to increase the call for a reassessment of whether Australia has a deep, high-quality corporate bond market.

Change in the presentation of the defined benefit cost

Under the revised AASB 119, the defined benefit cost comprises service cost, net interest and remeasurements. Service cost (current and past service cost and gains and losses on curtailments and settlements) and net interest are recognised in profit or loss, while remeasurements (actuarial gains and losses, any changes in the effect of the asset ceiling and the difference between the (expected) net interest income and the actual return) are recognised in OCI for retirement benefits and in profit or loss for other long-term employee benefits.

Introduction of more extensive disclosure requirements in the financial statements

The revised AASB 119 introduces more extensive disclosure requirements relating to the characteristics, risks and amounts in the financial statements regarding defined benefit plans, as well as the effect of defined benefit plans on the amount, timing and uncertainty of the entity's future cash flows.

Change in the definition of short-term employee benefits

The revised AASB 119 changes the definition of short-term employee benefits. Short-term employee benefits under the superseded AASB 119 were benefits that are ***due*** to be settled within 12 months after the end of the period in which the employees render the related service.

In contrast, under the revised AASB 119, only benefits that are ***expected*** to be settled ***wholly*** within 12 months after the end of the annual reporting period in which the employees render the related service are classified as short-term employee benefits. The inclusion of 'expected' and 'wholly' in the definition of short-term employee benefits might lead to a change of classification.

For example, for annual leave in Australia it is generally not required (or 'expected') that the accrued annual leave is wholly used (settled) before the end of the next annual reporting period. Due to the adjusted definition, similar benefits classified as short-term employee benefits under the superseded standard would be classified as long-term employee benefits under the revised AASB 119. The impact of this would be that annual leave classified as long term would need to be discounted allowing for expected salary levels in the future period when the leave is expected to be taken.

Taxation in defined benefit plans

In Australia, taxation applies to both investment earnings on plan assets, and employer contributions (also known as concessional contributions) paid into the defined benefit plan. Under the superseded AASB 119, there was uncertainty regarding how investments tax and contributions tax should be allowed for in determining the defined benefit disclosures.

The revised AASB 119 standard resolves some of this uncertainty in relation to allowance for contributions tax, which should result in more consistency of financial statement disclosures, as entities are generally expected to allow for contributions tax in the calculation of defined benefit obligation. However, the revised AASB 119 has not provided any clarification on investment tax compared to the superseded standard.

Questions for employers to consider now

- Should the employer adopt the revised AASB 119 earlier than the first reporting period starting in 2013?
- What implications would early adoption have (e.g. the treatment of any unrecognised actuarial gains and losses on transition to the new standard)?
- Will the nature of annual leave liabilities change from short-term to long-term employee benefits under the revised standard? If so, what impact will this have on the value of liabilities disclosed, and what assistance may the employer need to make this calculation?
- For employer sponsors of defined benefit plans, what is the estimated impact on the superannuation expense disclosed in the employer's income statement? What will be the impact on the retained profits position of the entity, given full recognition of deficit/surplus in the balance sheet under the revised standard?
- For employers considering a restructuring of their defined benefit arrangements, such as a defined benefit to accumulation transfer, will this be more or less attractive under the revised standard? As a result, should the employer bring forward or defer any benefit restructure?

The important changes in more detail

In this section, the changes made by the revised AASB 119 – Employee Benefits are discussed in more detail, with particular focus on the items expected to have most impact for Australian entities

The changes discussed in this section are:

- Full recognition of deficit (surplus) on the balance sheet
- Introduction of net interest on the net defined benefit liability (asset)
- Change in the presentation of the defined benefit cost
- Introduction of more extensive disclosure requirements in the financial statements
- Change in the definition of short-term employee benefits
- Taxation in defined benefit plans.

The revised AASB 119 clarified the definition and recognition of termination benefits, but this is not expected to have a significant impact for Australian entities and therefore it is not discussed further in this paper.

Full recognition of deficit (surplus) on the balance sheet

The deficit (surplus) in an entity's defined benefit plan under AASB 119 is equal to the difference between the present value of the defined benefit obligation ('DBO') and the fair value of plan assets. Under the revised AASB119, the net defined benefit liability (asset) recorded on the balance sheet is equal to the deficit (surplus) in the defined benefit plan and the possible effect of the asset ceiling.

Under the superseded AASB 119, this was not necessarily the case due to the possibility of deferring actuarial gains and losses using the 'corridor approach' and the requirement to recognise unvested past service costs over the average vesting period rather than immediately in the reporting period in which these occur. Deferred recognition leads to less volatile financial statements, which is the main reason why this treatment was permitted in the superseded AASB 119.

Deferred recognition of actuarial gains and losses

Actuarial gains and losses arise due to differences between expected and actual experience during the reporting period. As actuarial gains and losses can be either positive or negative, and depend on market conditions as well as entity-specific developments, the impact on the net defined benefit liability (asset) can change from year to year. In order to decrease volatility in profit or loss, the superseded AASB 119 permitted deferred recognition through the 'corridor approach'. Under the corridor approach, the cumulative unrecognised amount at the start of the reporting period was tested against a certain limit (corridor). Only the amount exceeding this limit was recognised in profit or loss, amortised over (at most) the expected future service years of the active participants.

Therefore, a two-step deferral mechanism was in place when using the corridor approach, decreasing impact on profit or loss but, therefore, also distorting the balance sheet position.

The superseded AASB 119 also permitted direct recognition either in profit or loss or in OCI, as a result of which all actuarial gains and losses are included in the net defined benefit liability (asset). Under the revised AASB 119, all actuarial gains and losses will be recognised in OCI in the reporting period in which they occur. Therefore, recognition of actuarial gains and losses in profit or loss, either on a deferred or immediate basis, will not be possible under the revised AASB 119.

Few Australian entities currently use the 'corridor approach' for recognising actuarial gains or losses – the ones who do tend to do so for consistency with U.S. GAAP reporting, typically where they have a U.S. parent. This means that most companies in Australia either recognise actuarial gains or losses through OCI or through their profit and loss statement. Therefore, the change to require immediate recognition of actuarial gains and losses is not expected to be an issue for most Australian entities' balance sheets.

The fact that the plan assets will be multiplied by the discount rate rather than the expected rate of return can have a significant impact on profit or loss of the entity

For those Australian entities which do use a 'corridor approach' at present, the impact of the revised AASB 119 will be that any unrecognised gains and losses on transition to the revised standard will be adjusted for through retained profits (i.e. equity).

The application of the revised AASB 119 will affect the current equity position and future profit or loss of entities currently using the corridor approach. Due to poor investment performance, decreasing discount rates, and changing mortality rates in recent years, most companies using the corridor approach have generally disclosed unrecognised actuarial losses.

These entities, therefore, present a smaller balance sheet liability (or larger balance sheet asset) than the actual deficit or surplus in the defined benefit plan. On application of the revised AASB 119, all cumulative unrecognised actuarial gains and losses at the start of the earliest comparative period will be recognised in retained earnings. If unrecognised actuarial losses are in place, application of the revised AASB 119 will decrease the equity position of the entity, leading to possible knock-on effects, such as issues with loan covenants or potential credit granting to the entity. Also, OCI will become more volatile in future years, as all changes of market-related assumptions (such as the discount rate) will be recognised in OCI. The balance sheet will, however, reflect the actual net defined benefit liability (asset) based on the revised AASB 119, which increases comparability between entities.

Deferred recognition of past service cost

Past service costs arise in case of a change of the employee benefit plan. Under the superseded AASB 119, when vesting requirements are in place with regard to the change of the defined benefit plan, past service cost (or a part of it) should be deferred when unvested. This results in an unrecognised amount which is amortised in profit or loss over the vesting period, typically based on a fixed amortisation schedule.

Under the revised AASB 119, all past service costs are recognised in profit or loss as they occur. Therefore, no unrecognised amount will exist relating to (unvested) past service cost after application of the revised AASB 119.

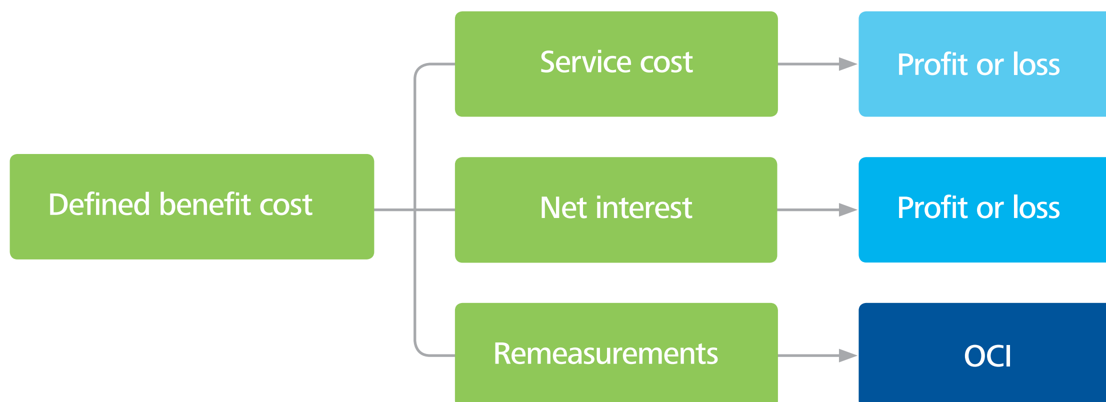
Concluding

The revised AASB 119 prohibits delayed recognition of actuarial gains and losses and past service cost. Therefore, the actual net defined benefit liability (asset) is reflected on the balance sheet. Also, OCI and profit or loss will become more volatile due to immediate recognition of actuarial gains and losses and past service cost when compared to the superseded AASB 119.

Introduction of net interest on the net defined benefit liability (asset)

Under the superseded AASB 119, the financing cost of defined benefit plans recognised in profit or loss are determined by the interest cost on the DBO and the expected return on plan assets. The discount rate by which the interest cost is determined is based on market yields on high-quality corporate bonds (or on government bonds in countries where there is no deep market in such bonds), while the expected return on plan assets is determined based on the expected rate of returns on investments over the entire life of the underlying obligation. The rate of return depends on the actual investment portfolio and is typically not equal to the discount rate. In general, the expected return on plan assets exceeds the discount rate due to investments in assets with a higher level of risk than high-quality corporate bonds (e.g. equities or property).

The revised AASB 119 introduces the net interest on the net defined benefit liability (asset), which will be recognised in profit or loss. The net interest on the net defined benefit liability (asset) is defined as the change of the net defined benefit liability (asset) during the reporting period that arises from passage of time and is determined by multiplying the net defined benefit liability (asset) by the discount rate, taking into account actual contributions and benefits paid during the reporting period. Effectively, this means that the DBO as well as the plan assets are both multiplied by the same discount rate.



With regard to AASB 119, the fact that the plan assets will be multiplied by the discount rate rather than the expected rate of return can have a significant impact on profit or loss of the entity.

When the actual return is equal to the expected return, based on superseded AASB 119 this has no impact on either profit or loss or OCI, as the actuarial gains or losses on plan assets equals zero. However, based on the revised AASB 119, the return on plan assets excluding the amount included in interest income will be recognised in OCI as part of remeasurements.

Although this change gives less room for interpretation by entities of the expected return assumption and will therefore improve comparability, in general the employee benefit cost of the entity recognised in profit and loss will increase. Also, effective asset management is not reflected in profit or loss but rather in OCI, which might be regarded by companies as a negative effect of the revised AASB 119. This change is implemented in order to exclude the reward for asset management risks run by entities from profit or loss.

In addition, while under the superseded AASB 119 all administration costs were deducted from the expected return (in profit or loss), under the revised AASB 119 only the (administration) costs relating to managing plan assets are deducted from the actual return (in OCI) and all other administration costs should be recognised in profit or loss when they occur.

Change in the presentation of the defined benefit cost

Under the superseded AASB 119, the pension expense recognised in profit or loss consists of several components, such as current service cost, interest cost and expected return on plan assets, as well as (depending on the entity's accounting policy) the recognition of actuarial gains and losses. The superseded standard had little guidance on the presentation of these items within profit or loss and in practice a number of presentations were used.

The revised AASB 119 is more prescriptive and introduces the term 'defined benefit cost'. The defined benefit cost comprises all costs (incomes) during a reporting period that lead to the development of the net defined liability (asset), excluding contributions paid.

As shown in the diagram above, the defined benefit cost is disaggregated in the following components:

- Service cost, which comprises
  - Current service cost
  - Past service cost
  - Curtailment and settlement gains and losses
- Net interest on the net defined benefit liability (asset)
- Remeasurements of the net defined benefit liability (asset), which comprise
  - Actuarial gains and losses on the DBO
  - The return on plan assets, excluding amounts included in net interest on the net defined liability (asset)
  - Any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined liability (asset).

Under the superseded AASB 119, actuarial gains and losses and any changes in the effect of the asset ceiling could be recognised in profit or loss. Under the revised AASB 119, these items must be recognised in OCI, as well as the difference between the (expected) net interest income on the plan assets and the actual return (AASB 119: Actuarial gains and losses on plan assets). Profit or loss based on the revised AASB 119 will, therefore, only include service cost and net interest.

Introduction of more extensive disclosure requirements in the financial statements

According to the revised AASB 119, reporting entities should disclose information that:

- Explains the characteristics of and risks associated with its defined benefit plans
- Identifies and explains the amounts in its financial statements arising from its defined benefit plans and
- Describes how its defined benefit plans may affect the amount, timing and uncertainty of the entity's future cash flows.

These disclosure requirements are more extensive than the disclosure requirements in the superseded AASB 119 and will provide additional insight into the pension situation at the entity. Narrative descriptions of (for example) the regulatory framework, funding arrangements, potential (non-)financial risks and/or asset ceiling tests should be included in the financial statements according to the revised AASB 119.

Examples of these more extensive disclosure requirements are:

- The disclosure of the nature of the benefits
- A description of the risks to which the employee benefit plan exposes the entity
- The results of a sensitivity analysis that indicates the influence of certain assumptions on the outcome of the pension valuation
- A narrative description of funding arrangements
- Information about the maturity profile including the duration of the pension liabilities
- Entities that participate in a multi-employer defined benefit plan should, for example, disclose:
  - The extent to which the entity is liable for other entities' obligations
  - Qualitative information about agreed deficit/surplus allocation on wind-up or withdrawal.

Based on this information, users of the financial statements should be provided with additional insight of the entity's obligations regarding employee benefits. The additional disclosure requirements will, on the other hand, most likely lead to higher costs for the entity in gathering information to meet the disclosure requirements of defined benefit plans in the financial statements.

Change in the definition of short-term employee benefits

The revised AASB 119 changes the definition of short-term employee benefits. Short-term employee benefits under the superseded AASB 119 were benefits that are ***due*** to be settled within 12 months after the end of the period in which the employees render the related service.

In contrast, under the revised AASB 119, only benefits that are ***expected*** to be settled ***wholly*** within 12 months after the end of the annual reporting period in which the employees render the related service are classified as short-term employee benefits. The inclusion of 'expected' and 'wholly' in the definition of short-term employee benefits might lead to a change of classification.

For example, for annual leave (paid leave which is accumulated by employees over time) it is generally not required (or 'expected') that the accrued annual leave is wholly used (settled) before the end of the next annual reporting period. Due to the adjusted definition, similar benefits classified as short-term employee benefits under the superseded standard might be classified as long-term employee benefits under the revised AASB 119.

Short-term employee benefits are accounted for on an undiscounted basis in the period in which the service is rendered. For employee benefits that classify as other long-term employee benefits, discounting is required and salary increases (for example) should be incorporated. The change of the definition might have an impact on the (net) balance sheet liability regarding those employee benefits and, therefore, on the financial statements of an entity.

Under the revised AASB 119, annual leave classified as long term will need to be discounted by Australian entities

In Australia, it is common for employees not to take all of their annual leave each year and, accordingly, annual leave balances often accrue for a number of years, which means that the annual leave liabilities are generally a material amount for companies. Currently, under the superseded AASB 119 annual leave is typically treated as a short-term employee benefit. Under the revised AASB 119, these annual leave benefits would generally fail the revised definition of 'short-term employee benefits' and would thus fall into the 'other long-term employee benefits' definition.

Australian entities that currently treat annual leave as a short-term benefit under the superseded AASB 119 result in the provision not being discounted. However, annual leave benefits which are classified as other long-term employee benefits under the revised AASB 119 (i.e. where they are not expected to be wholly settled within 12 months) will need to be discounted allowing for expected salary levels in the future period when the leave is expected to be taken. This will typically result in a reduction in reported annual leave liabilities, except where the discount rate under AASB 119 may be less than the assumed rate of salary increases for employees in which case the annual leave liability disclosed would in fact be higher than previously.

For completeness, we note that long service leave employee benefits continue to be classified as other long term employee benefits under the revised standard and hence their treatment is unchanged.

Taxation in defined benefit plans

In Australia, taxation applies to both investment earnings on plan assets, and employer contributions (also known as concessional contributions) paid into the defined benefit plan.

Under the superseded AASB 119, there was uncertainty regarding how investments tax and contributions tax should be allowed for in determining the defined benefit disclosures. For example, some entities have deducted contributions tax from the investment earnings of the plan and recognised this as part of actuarial gains and losses for the period, while other entities have argued that return on assets exclude contributions tax and instead they have factored this into the DBO.

The revised AASB 119 standard resolves some of this uncertainty in relation to allowance for contributions tax. In particular, it states that the financial assumptions should deal with taxes payable on contributions relating to accrual of benefits in respect of past service. The definition of return on plan assets specifically excludes allowance for contributions tax. This amendment should result in more consistency of financial statement disclosures, as entities are generally expected to allow for contributions tax in the calculation of DBO.

However, the revised AASB 119 has not provided any clarification on investment tax compared to the superseded standard. In particular, there is uncertainty regarding what allowance (if any) should be made for investment tax in the calculation of the net interest on net defined benefit liability (asset), and how any such allowance should be made. The revised AASB 119 has not addressed the concerns of some auditors regarding the use of a net discount rate.

Areas of uncertainty, such as the above issues with respect to superannuation taxes in Australia, represent matters of interpretation of the accounting standards. As such, it is not possible to be definitive regarding how taxes should be allowed for under the revised AASB 119, and you should seek guidance from your professional adviser(s) and/or auditor.

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