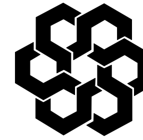

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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **17 November 2006, London**

Project: **Post-employment Benefits**

Subject: **Presentation of changes in defined benefit pension plans (Agenda Paper 4B)**

Introduction

1. In Agenda Paper 4A, the staff recommended that the Board propose immediate recognition of all gains and losses arising from changes in the pension obligation.

2. This paper considers presentation of gains and losses arising from changes in defined benefit pension plans. In particular, this paper considers:

   (a) whether any of the following components of a defined benefit pension plan (as identified in IAS 19) should be recognised outside profit or loss:

      (i) service cost (current and past).

      (ii) interest cost.

      (iii) returns on plan assets.

      (iv) actuarial gains and losses.

   (b) if so, should any of that amount be recycled to profit or loss?

3. In finalising IAS 19 in 1998, the IASC Board noted that requiring immediate recognition of gains and losses would be feasible only when substantial issues about performance reporting were resolved. However, at its July 2006 meeting, the Board noted that it could require immediate recognition of all gains and losses if those gains and losses are presented appropriately.

4. Paragraph 26 of the July Board paper (see below) described the staff's approach and rationale, with which the Board agreed. The last sentence is, in the staff's view, the important point. The Financial Statement Presentation project is developing innovative approaches, but those approaches have yet to be incorporated in a due process document. If this project is to move forward, we need to work with the tools at hand.

> Item (e) presentation. Why would we ask the Board to consider those issues in the pensions project, rather than leaving them in the presentation project? We have three reasons. First, the Board's constituents will not know how to respond to other proposals without knowing how the Board expects the results to be displayed. They will want, and we should provide, a full picture of the proposed changes. Second, we expect that some Board members will resist the idea of reporting all changes in pension obligations through profit or loss. Third, a four-year timetable does not permit the pensions project to be tied to progress on other projects.

Staff recommendations

5. As in Agenda Paper 4A, the staff recommendations are designed to elicit the Board's preliminary views for a Discussion Paper. The staff recommends that all components of a defined benefit plan are recognised in profit or loss in the period in which they arise. The staff also recommends that the alternative approaches set out in paragraphs 46-50 be included in the Discussion Paper.

Staff analysis

6. The following paragraphs discuss the presentation of each component of pension cost (other than settlements and curtailments, which will be discussed in a future meeting).

7. Phase I does not contemplate any changes to the basic methodology in IAS 19. Each of the components of pension cost discussed in this paper is calculated in accordance with IAS 19. Each component is discussed individually. However,

as noted in paragraph 14, some Board members and constituents may prefer to think of one or more components as being related, and thus that presenting those components in the same component of profit or loss or equity is of more importance than where each individual component is presented. The impact of such linkage is discussed in paragraphs 43-44.

8. As with Agenda Paper 4A, the staff has not attempted to repeat the analysis found in the Basis for Conclusions to IAS 19 and FASB Statement No 87. Most Board members are familiar with those discussions, but we have included them as attachments to Agenda Paper 4A (pages 73-120 of IAS 19 and 30-69 of SFAS 87). [Not reproduced as Observer Notes.]

9. The discussion about the presentation of components of pension cost should be read in the context of the following:

   (a) The presentation of items of income and expense in the financial statements is under discussion generally. An Exposure Draft of amendments to IAS 1 *Presentation of Financial Statements* was published earlier this year and the Board also is undertaking a joint project with the FASB on financial statement presentation. As discussed earlier, Phase I of this project aims to find an interim solution to the presentation of the components of pension costs – one that accommodates immediate recognition of all gains and losses within the framework of the amended IAS 1. Better and more innovative approaches for the presentation of pension costs may be developed outside the framework of IAS 1. However, those approaches should be explored in the financial statement presentation project rather than phase I of the post-employment benefits project. In this paper, the staff has used the terminology of the proposed amendments to IAS 1 assuming that an entity presents two statements, a statement of profit or loss and a statement of other recognised income and expense.

   (b) Items of income and expense are generally recognised in profit or loss in accordance with IAS 1. However, some items are recognised outside profit or loss. A clear conceptual basis for deciding which items are recognised outside profit or loss has not been established, although some Board members argue that some general underlying factors can be identified (see paragraph 29).

Service costs

Current service cost

10. Current service cost is defined as "the increase in the present value of the defined benefit obligation resulting from employee service in the current period." It is the best estimate of the cost of providing the benefit earned by the employees in the period. Current service cost is recognised in profit or loss under IAS 19 and SFAS 87 and the staff is unaware of any reason why this should be changed.

Past service costs

11. Past service cost is defined as "the increase in the present value of the defined benefit obligation for employee service in prior periods, resulting in the current period from the introduction of, or changes to post-employment benefits or other long-term employee benefits". Under IAS 19, unamortized, unvested past service cost is not recognised. Vested past service cost and the amortisation of unvested past service cost are recognised in profit or loss for the period. Agenda paper 4A recommends that the Board require recognition of all past service costs.

12. Past service cost arises from an action taken by the entity in the period (i.e. changing the plan terms). It is the cost of introducing new benefits, rather than a remeasurement of existing benefits. As such, the staff is persuaded, as was the IASC, that it should be presented in profit or loss in the period in which it arises.

Components other than service costs

13. The following sections set out an analysis of each of the other components of pension costs other than service costs.

14. The staff has analysed each component separately. However, the staff notes that many constituents regard the offset of (i) the interest cost on the pension obligation and (ii) the returns on plan assets as being an important economic effect of a funded plan. The Basis for Conclusion to IAS 19[1] also notes that

[1] Paragraph 47

"changes in plan assets are the results of changing estimates by market participants and are, therefore, inextricably linked with changes in the present value of the obligation. Consequently, the [IASC] Board decided that changes in the fair value of plan assets are actuarial gains and losses and should be treated in the same way as the changes in the related obligation." Thus, some would argue that it is necessary to determine where to present changes in plan assets in conjunction with the interest cost and possibly other changes in the defined benefit obligation.

15. Some staff reject the argument just cited language from the Basis. As written, it contradicts the premise in IAS 19 and IAS 37 that the measurement of a liability is independent of the measurement of related assets. A change in the value of, say, EADS, or any portfolio of equity instruments is not relevant to the measurement of a defined benefit pension obligation. In fairness to Peter Clark, he reports that he intended the passage from IAS 19 to focus on the high-quality corporate bond rate **portion** of both the pension liability and an asset portfolio.[2]

16. As a result, in the discussion below, the staff makes recommendations specific to each individual component. Paragraphs 43-44 then discuss the impact of their possible linkage.

Interest cost

17. The interest cost of a defined benefit pension obligation is computed by multiplying the present value of the defined benefit obligation throughout the period, taking account of any material changes in the obligation, by the discount rate as determined at the start of the period (see paragraph 82 of IAS 19). IAS 19 requires that interest cost to be recognised in profit or loss.

18. Considered by itself, the staff is unaware of any reason to amend the currently required treatment of interest costs.

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[2] We referred to Zvi Bodie's article, *On the Risk of Stocks in the Long Run*, during the October Board meeting. The article makes the point more cogently than any other that we have seen. A copy is attached to this Board paper.

Return on plan assets

19. IAS 19 currently requires identification of an expected return on plan assets. The expected return on plan assets is recognised in profit or loss and the remainder of the actual return on assets forms part of the actuarial gains and losses on the defined benefit pension plan.

20. Including "expected" rather than "actual" returns on plan assets in profit or loss is a method of smoothing away the short-term volatility associated with equity returns. However, it can be argued that the expected return on plan assets does not provide a faithful representation of the underlying gain or loss for the period. There are also concerns that the expected return on plan assets is a subjective assumption that presents entities with an opportunity to choose an expected rate of return with a view to achieving a particular result.

21. The staff notes that it would be consistent with the presentation of interest cost on the liabilities to present a component representing interest income on the assets. Both amounts would represent the change in the current/fair value of the liability/asset arising because of the passage of time. For fixed interest securities, such a component could be calculated in the same way as the interest cost. For equity securities, determining current value interest income would be difficult. (Some staff consider the notion of "interest" on equity securities other than preferred stock to be meaningless.) There are also questions over the usefulness of the information given by splitting the total change in fair value of interest-bearing assets into an interest income amount and the remaining change in value. This question can be discussed further in phase two of the project. In the meantime, the staff recommends that the split of the total return on assets into an expected return and an actuarial gain or loss is eliminated.

22. Some staff take a different view. They acknowledge that any split between the total change in an instrument's fair value and the portion that represents "interest" is arbitrary. However, IAS 19's liability measurement includes an interest element that uses current interest rates. We could extract a similar element from the change in the value of interest-bearing assets, add dividends received on equity instruments (perhaps), and have an amount that is notionally

similar to the interest element of annual pension cost. This would produce a fourth alternative, in addition to the three discussed below.

23. If the Board eliminates the expected return on plan assets, the question remains how changes in the fair value of plan assets should be presented. We see three possibilities:

    (a) All changes in profit or loss.

    (b) The existing treatment of available for sale assets under IAS 39, ie changes presented outside profit or loss, other than interest calculated using the effective interest method and dividends for which the entity's right to receive payment is established.

    (c) All changes outside profit or loss.

All changes in profit or loss

24. One option would be to present all changes in the fair value of plan assets in profit or loss. This approach would have the following advantages:

    (a) It would be consistent with the accounting for financial assets at fair value through profit or loss, i.e. plan assets would be measured, recognised and presented in the same way as other financial assets to which an entity had elected to use the fair value option.

    (b) It would be consistent with the presentation of changes in fair value of other assets, such as investment properties and agricultural assets.

    (c) Profit or loss would reflect the difference in risks between a funded and an unfunded plan.

25. However, presenting changes in the fair value of plan assets would not address the concerns about the presentation of volatility on long-term items in profit or loss that have been expressed by constituents in the past. Although this project seeks to improve financial reporting by recognising immediately all components of the pension obligation, it does not do so with the benefit of the outcome of the financial statement presentation project or a comprehensive rethink of the accounting for post-employment benefits.

Changes presented outside profit or loss, other than interest and dividends

26. Alternatively, changes in the fair value of plan assets could be presented in the same way that changes in the fair value of available-for-sale financial assets are presented. Accordingly, changes in the fair value of assets would be presented in the statement of other recognised income and expense. Dividends received on equity instruments and interest calculated using the effective interest method would be recognised in profit or loss. This approach has the following advantages:

    (a) it would be consistent with the required accounting for other financial assets held by the entity.[3]

    (b) it does not require entities to report in full the volatility associated with plan assets, pending further progress in the financial statement presentation project.

27. The main disadvantage of this approach is that the return on plan assets that would be presented in profit or loss is not a current or fair value interest cost. Rather it would be determined using a method that allocates the interest cost over the relevant period and recognises cash dividends on equities. This results in the following implications:

    (a) Changes in the pension obligation are fair value changes, including the interest cost. To the extent that these are presented in profit or loss, there would be a mismatch between the measurement bases for the returns on the assets and the expense on the liabilities that are presented in profit or loss. Many constituents would probably regard that mismatch as significant.

    (b) All the components of the pension cost under IAS 19 are based on current values. The staff regards a requirement to recognise a return on assets in profit or loss that is calculated using a basis other than current values as a step backwards.

    (c) A particular example illustrating points (a) and (b) is a plan funded in fixed interest investments. Under existing IAS 19, the current value interest cost and a current value interest income are both recognised in profit or loss.

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[3] IAS 39 specifies four measurement categories for financial assets. However many plan assets would be equity investments and would not qualify for categorisation as held-to-maturity assets or loans and receivables. Plan assets also do not meet the definition of held-for-trading assets. If the entity were to designate plan assets as at fair value through profit or loss, this would be equivalent to the option in paragraph 24.

Under this proposal, the interest income in profit or loss would be based on historical cost.

28. Another disadvantage is that changes in the fair value of available-for-sale financial assets that have been recognised in equity are recycled to profit or loss when the financial asset is derecognised. Thus, gains and losses would be recognised in profit or loss depending on which plan assets have been realised. These gains and losses would create arbitrary volatility in profit or loss.

All changes outside profit or loss

29. A third approach would be to require the recognition of *all* changes in the fair value of plan assets outside profit or loss. The advantage of this approach is that the presentation would be consistent with the presentation of assets remeasured at fair value in accordance with IAS 16 and IAS 38. Some Board members argue that the underlying rationale for recognising those items[4] outside profit or loss is that volatility on long-term item assets and liabilities is not the same as short-term operating income and expenses and should be presented separately. Entities would not be required to report the volatility associated with plan assets in profit or loss, pending further progress in the financial statement presentation project.

30. The disadvantage of this approach, especially if interest costs on the defined benefit obligation are recognised in profit or loss, would be that *no* interest income would be recognised in profit or loss for any period. As noted in paragraph 14, many constituents would object to recognising interest income and interest expense in different components of profit or loss and equity.

31. Considered on its own, the staff would recommend that the return on plan assets should be presented in the same was as changes in value of available for sale assets in accordance with IAS 39. Why should pension plan assets be treated differently from assets held directly by the entity? Reasons for considering the return of plan assets differently, together with other components of the pension cost are discussed in paragraphs 43-44.

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[4] And other items currently recognised outside profit or loss, such as foreign exchange differences on overseas subsidiaries.

Actuarial gains and losses

32. For the purposes of this section, actuarial gains and losses include changes to the defined benefit pension obligation, including the effect of changes in discount rates, but not changes in plan assets. This is because the staff has recommended that the return on plan assets be considered as a whole and thus departures from expected returns on plan assets are no longer included in actuarial gains and losses.

33. The following alternatives are discussed.

    (a) All in profit or loss.

    (b) Non-financial assumptions in profit or loss, financial assumptions outside profit or loss.

    (c) All outside profit or loss.

All in profit or loss

34. Actuarial gains and losses arise from:

    (a) changes in actuarial assumptions (changes in the estimated cost of employee service); and

    (b) experience adjustments, i.e. differences between the previous actuarial assumptions and what has actually occurred. Experience adjustments arise from events before the balance sheet date and resolve a past estimate.

35. IAS 8 requires that the effect of changes in accounting estimates should be included in profit or loss for the period if the change affects current period only but not future periods. Thus, IAS 8 would require actuarial gains and losses to be included in profit or loss for the period.

36. This approach would also be consistent with the accounting for liabilities in accordance with IAS 37.

Non-financial assumptions in profit or loss, financial assumptions outside profit or loss

37. Another approach would be to recognise some actuarial gains and losses in profit or loss, and some outside. The staff considered whether:

(a) those relating to non-financial assumptions be presented in profit or loss. Such changes can be viewed as representing changes in volume (e.g. changes in demographic assumptions affecting the number of employees drawing pensions).

(b) those relating to financial assumptions, which would be presented outside profit or loss. This would include the effect of changes in the discount rate and future salary and benefit levels.[5] Such changes can be viewed as representing changes in the price of providing benefits.

38. Such an approach would provide some conceptual basis to distinguish the gains and losses presented in profit or loss from those presented outside profit or loss. However, it has the following disadvantages:

(a) It would require prescriptive and arbitrary rules about how to divide the effect of the assumptions between financial and non-financial assumptions. This is because the financial and non-financial assumptions are interrelated eg rates of employee turnover depend on future salary and benefit levels. Although elements relating to financial or non-financial assumptions can be identified, there is a joint element relating to both financial and non-financial assumptions. Allocating the value of the joint element to financial or non-financial assumptions is arbitrary because it is, by its nature, joint. Further, the amount of any overall change in assumptions allocated to any individual change in assumption also depends on the order in which the assumptions are assumed to have changed. Finally, there may be differences in opinion as to which assumptions are financial and which are non-financial.

(b) It would require the division of actuarial gains and losses in a way that is not currently required by IAS 19. As a result, it is more complex than other options being considered.

All outside profit or loss

[5] For consistency with this approach, the return on plan assets should also be recognised outside profit or loss.

39. The Board has previously concluded that actuarial gains and losses are items of income and expense.[6] However, IAS 19 permits, as an accounting policy choice, recognition of actuarial gains and losses outside profit or loss. The advantages of mandating this approach are:

    (a) It is consistent with the view that volatility on long-term items should be presented separately from short-term income and expenses

    (b) It is consistent with the Basis for Conclusions when the option was introduced which stated

    > "The IASB does not believe that immediate recognition of actuarial gains and losses outside of profit or loss is necessarily ideal. However, it provides more transparent information than deferred recognition. The IASB therefore decided to propose such an option pending further developments on the presentation of profit or loss and other items of recognised income and expense."[7]

    It could be argued that we still need to wait for further developments in financial statement presentation before requiring immediate recognition in profit or loss.

40. The disadvantages of such an approach are that it is inconsistent with the presentation of changes in liabilities (which are often long-term liabilities) under IAS 37. We would be requiring a new item to be presented outside profit or loss, arguably without the necessary conceptual framework in place for making such a decision.

41. Considering actuarial gains and losses as an individual component, the staff would recommend their presentation in profit or loss.

Overall staff recommendations and alternatives

42. Considered individually, the staff recommendations for each component are as follows:

    (a) Service cost, current and past, should be presented in profit or loss

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[6] IAS 19, Basis for Conclusions, paragraph 48K

[7] IAS 19, Basis for Conclusions, paragraph 48G

(b) Interest cost should be presented in profit or loss

(c) Return on plan assets should be presented in the same way as changes in value of available for sale assets under IAS 39, ie changes in the fair value of assets would be presented in the statement of other recognised income and expense. Dividends received on equity instruments and interest calculated using the effective interest method would be recognised in profit or loss.

(d) Actuarial gains and losses should be presented in profit or loss.

43. In the case of service costs, the staff argues that there is no linkage with other components that would cause a different view to be taken.

44. In respect of the other components, the staff argues that presenting dividends received on equity instruments and historical cost interest in profit or loss is not appropriate for plan assets measured at fair value, particularly when the interest cost on the defined benefit obligation in profit or loss is measured using current values. In order to achieve the offset that many argue exists between effects of changes in economic assumptions on the plan assets and the defined benefit obligation, the staff recommends that all changes in the value of the plan assets should be recognised in profit or loss. In other words, all components of the pension cost should be recognised in profit or loss.

45. The staff acknowledges that many constituents will argue that immediate recognition of the change in value of the plan assets and the actuarial gains and losses on the defined benefit obligation is premature, given the issues still to be resolved in financial statement presentation. The staff also thinks that elimination of deferred recognition is more important than presentation. The staff therefore argues that the Discussion Paper should include two other approaches, as follows.

Alternative 1

46. Alternative one would be the staff recommendations for each component considered individually, i.e. an approach that treats the plan assets and liabilities in accordance with IFRSs as if they were any other asset or liability. That would mean treating plan assets as if they are available-for-sale financial

assets in accordance with IAS 39, and treating the defined benefit obligation in accordance with IAS 37.[8] In other words:

(a) service cost, interest cost and actuarial gains and losses on the defined benefit obligation would be recognised in profit or loss;

(b) dividends and historical cost interest income on the plan assets would be recognised in profit or loss; and

(c) changes in the fair value of the plan assets would be recognised in the statement of other recognised income and expense.

47. The advantages and disadvantages of this approach for the individual components are discussed above. Overall, it has the advantage that there is no special treatment for pension costs under IFRSs. In linkage terms, however, it has the following disadvantages:

(a) A realised dividend and historical cost interest income amount is recognised in profit or loss compared to a current value interest cost on the liability

(b) The effects of changes in potentially linked economic assumptions on the assets and liabilities are presented in different statements.

Alternative 2

48. The second alternative would be an approach that continued the view that pension plans are long-term items and that their volatility should be presented separately. Under such an approach, the staff would argue that transparency and simplicity should be the overriding objectives. In the staff's view, that would mean:

(a) No split of the actual return on plan assets into an expected return and an actuarial gain or loss.

(b) Presentation of interest cost in the same statement as the return on plan assets

(c) No division of the actuarial gains and losses on the defined benefit obligation into different types.

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[8] IAS 39 requires most liabilities to be measured at amortised cost using the effective interest method. The staff believes that IAS 37 is a more appropriate model for the defined benefit obligation as it would not measure the obligation at amortised cost.

(d) No recycling of items recognised outside profit or loss in an earlier period.

49. The staff concludes that such an approach would involve presentation of:

    (a) service costs, current and past, in profit or loss and

    (b) all other components outside profit or loss.

50. The advantages and disadvantages of this approach for the individual components are discussed above. In linkage terms it has the advantage that all possible economic offsets that arise on changes in the plan assets and plan liabilities are presented together.

Recycling

51. IAS 19 does not permit the recognition of gains and losses in profit or loss that had been recognised outside profit or loss in an earlier period. In the Basis for Conclusions to IAS 19, the Board noted "that there is not a consistent policy on recycling in IFRSs and that recycling in general is an issue to be resolved in its project on reporting comprehensive income."[9] It also noted that "the question of recycling …remains open in IFRSs" and that it "does not believe that a general decision on the matter should be made in the context of [amendments to IAS 19]. "the decision […] not to recycle actuarial gains and losses is made because of the pragmatic inability to identify a suitable basis". The staff believes that this logic remains true in Phase 1 of this project and does not recommend that the Board require recycling of items recognised outside profit or loss in an earlier period. The staff also notes that the IASB has never *introduced* recycling in any of its standards.

52. We note further that there is nothing in the FASB's definition of *comprehensive income* or the IASB's definition of *other recognised income and expense* that presupposes that items should be recycled. Rather, we see the decision as one that has been, and should be, made in each standard. Some staff members place relatively greater weight on the inability to describe a nonarbitrary method for recycling actuarial gains and losses. Others place relatively greater weight on what they consider conceptual arguments against recycling. However, we all arrive at the same recommendations in this case.

53. The staff also makes the following points on recycling in respect of each option.

    (a) if the Board decides to propose that all components should be presented in profit or loss, the question of recycling goes away.

    (b) if the Board decides to propose that plan assets are presented in accordance with IAS 39 and the defined benefit obligation in accordance with IAS 37, again the question of recycling is not relevant. IAS 39 already requires that the cumulative gain or loss on the plan assets would be recognised in profit or loss when the assets are derecognised and, under IAS 37, no recyling is necessary because all gains and losses are recognised in profit or loss.

    (c) If the Board decides to propose presentation of all components apart from service cost outside profit or loss, the staff would argue for a simple and transparent approach. Only service cost is recognised in profit or loss. No other components ever become service costs in later periods so no recycling is appropriate.

A note on convergence with US GAAP

54. In September 2006, the FASB published the results of phase 1 of its post-employment benefits project, SFAS 158 *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*. To be similar to the FASB's requirements, the Board would have to require that:

    (a) service cost, interest cost and an expected return on plan assets be recognised in profit or loss

    (b) actuarial gains and losses, including a component of the return on plan assets be recognised outside profit or loss.

55. This approach has the disadvantage of perpetuating the need to calculate an expected return on assets. FASB also requires the recycling of items recognised outside profit or loss. Further, even if the Board were to require the SFAS 158 approach there would still be differences between US GAAP and IFRSs. This is because of the effects of the different requirements relating to recognition of past service cost in profit or loss, the recognition of actuarial

[9] IAS 19 Basis for Conclusions, paragraph 48P

gains and losses in profit or loss for plans with no active members, the asset ceiling and transition adjustments.