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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**December 2007, London**
Project:	**Post-employment benefits**
Subject:	**Sweep issues arising from the first preballot draft of Preliminary Views on Amendments to IAS 19 Employee Benefits (Agenda paper 13)** **Agenda paper 13A "Non-drafting Comments on the Preballot Draft of Preliminary Views on Amendments to IAS 19" is not provided in observer notes.**

Introduction

1. In November, the Board reviewed the first preballot draft of Preliminary Views on Amendments to IAS 19 *Employee* Benefits. This paper identifies issues raised by Board members that the staff believes should be discussed by the Board as a whole. This paper discusses the following issues:

   (a) Classification of promises that include a fixed return.

   (b) Classification of promises of a regular fixed amount after retirement.

   (c) Classification of promises that IAS 19 classifies as defined contribution.

   (d) Disaggregation and presentation of changes in contribution-based promises.

   (e) The tone of the chapter on presentation approaches, in particular for approach 3.

2. Other issues raised by Board members are set out in Agenda Paper 13A [not provided in observer notes], with proposed staff action. If any Board member wishes to raise any other issue for discussion in a Board meeting, the staff would appreciate as much advance notification as possible.

3. Members of the Employee Benefits Working Group were asked to perform a fatal flaw review on the chapters dealing with contribution-based promises. No fatal flaw was identified. Issues raised by the members of the Working Group are included in Agenda Paper 13A [not provided in observer notes].

Next steps

4. After the Board discussion, the staff intends to circulate a second preballot draft that will reflect the Board's decisions and the other comments received on the first preballot draft. [Sentence omitted from observer notes]

5. [Paragraph omitted from observer notes]

Summary of staff recommendations

6. The staff recommends:

   (a) the scope of contribution-based promises should include promises with a guaranteed fixed return (see paragraphs 7-23).

   (b) the Discussion Paper explicitly states that promises of a regular fixed amount after retirement are classified as follows:

      (i) as a contribution-based promise, if the Board retains the classification of promises of fixed return as contribution-based; or

      (ii) as a defined benefit promise if the Board classifies promises of fixed return as defined benefit. (See paragraphs 24-28.)

   (c) the scope of contribution-based promises should include defined contribution plans as currently defined in IAS 19 (see paragraphs 29-40).

   (d) the Discussion Paper is redrafted to:

      (i) be less definite about the Board's preliminary view on disaggregation and presentation for contribution-based promises;

      (ii) spell out the differences in presentation between contribution-based and defined benefit promises that result from those preliminary views; and

(iii) ask a question in the Invitation to Comment on these matters. (See paragraphs 41-46.)

(e) approach three should be presented in a less negative manner by:

(i) removing the preliminary view that there should be no expected return on plans assets from chapter 2. The preliminary view in chapter 2 that no gains and losses should be deferred would remain, and the staff will if necessary amend the drafting to make it clear that this preliminary view covers gains and losses on plan assets as well as gains and losses on plan liabilities.

(ii) the discussion of desegregation of changes in fair value in chapter 3 is made less definitive, noting that some users do find the information useful.

(iii) additional arguments in favour of imputed interest and an expected return are included in the Discussion Paper and the comment that none of the three methods of identifying an interest income amount are satisfactory is deleted. (See paragraphs 47-57.)

Issues

Classification of promises that include a fixed return

7. The Board has tentatively concluded that promises of a fixed return on contributions should be included in the category of contribution-based benefit promises. An example is promise 5 in the pre-ballot draft:

Promise 5: The employer promises to make notional contributions of 5% of the employee’s current salary for each year of service. The benefit promise at retirement is a lump sum equal to the contributions plus a fixed return on the contributions of 3% per year.

8. This is a contribution-based promise because it is economically identical to a promise with returns equal to the return on the equivalent zero coupon Government bond.

9. Some Board members and other constituents disagreed with the classification of promises with guaranteed fixed returns as contribution-based. Although they agree, in principle, that such promises meet the definition, they argue that the practical consequences of treating guaranteed fixed returns as contribution-based

instead of defined benefit are significant, unwelcome and unnecessary in phase I of the project.

10. The staff has set out below what these consequences are and would like to ask the Board whether it wishes to reconsider the categorisation of benefit promises with guaranteed fixed increases.

11. The main consequences are:

    (a) a considerable increase in the scope of Phase I.

    (b) inconsistency between career average and other salary-related promises.

    (c) promises that appear intuitively to be defined benefit are categorised as contribution-based.

Increase in scope

12. The purpose of Phase I of the project is to address the accounting for those promises for which the application of the current IAS 19 measurement requirements is inappropriate. The application of current IAS 19 measurement requirements to promises with guaranteed fixed returns or to benefit promises linked to assets that yield guaranteed fixed returns is unproblematic. Therefore, it is argued that including such promises in the contribution-based category would extend the scope of Phase I unnecessarily.

13. In particular, they note that decisions on the other issues in Phase I have been based on pragmatic considerations whereas the decision regarding guaranteed fixed returns has been based on a conceptual preference even though it does not solve any practical problems and is likely to be unwelcome in practice.

14. Career average and other salary-related promises

15. Career average promises are economically identical to current salary promises. Therefore, they would be classified as contribution-based promises. Accordingly:

    (i) the liability for benefits under a career-average salary promise would be measured at fair value assuming the benefit promise does not change;

    (ii) the measurement of the liability for benefits under a career-average salary promise would not include expectations about future salary increases;

(iii) all changes in the liability for career-average salary promises would be presented in profit or loss in the period in which they occur.

Other salary-related promises are classified as defined benefit. They are measured using the projected unit credit method, including expectations about future salary increases. Recognition and presentation of defined benefit plans is discussed in chapters 2 and 3 of the Discussion Paper.

16. Some argue that the resulting significant differences in accounting are not commensurate with the potentially small difference in practice between career average and other salary-related promises. Further, one Board member raised a concern that an entity could easily avoid contribution-based classification and get defined benefit accounting if it had a career average plan but included a feature that would throw out, for example, the lowest two years in the average. That means that the benefit cannot be expressed in terms of current salary without salary revaluation, so it is a defined benefit promise, not a contribution-based promise.

17. If benefit promises with guaranteed fixed returns were classified as defined benefit, career-average promises with fixed returns would be accounted for in the same way as other salary-related promises.

18. Of course, if guaranteed fixed increases are classified as defined benefit, then a new discrepancy would arise. For instance, promises linked to an index would be classified as contribution-based, while promises linked to guaranteed fixed returns (which are sometimes similar to index-linked promises) would be DB. However, many think that this discrepancy is much smaller than the one that arises between career average and other salary-related promises if guaranteed fixed returns are classified as contribution-based.

19. The staff notes also that many career average plans are linked to inflation or some other form of revaluation, other than guaranteed fixed returns. The Board's preliminary view is that promised returns linked to inflation are contribution-based. Therefore these career average promises would be classified as contribution-based and treated differently from other salary-related plans, unless inflation-linked promises are also classified as DB.

Intuitive Classifications

20. There are a number of promises that appear to be defined benefit that would be classified as contribution-based because guaranteed fixed returns are contribution-based. These include:

    (i) fixed lump sums,

    (ii) regular payments of a specified amount after retirement

21. Many constituents expressed the view that fixed lump sums should be classified as defined benefit. A note from one constituent expressing such a view is attached as an appendix [not provided in observer notes].

22. Further, at the October meeting, some Board members stated that a promise of regular payments of a specified amount after retirement appears to be defined benefit because the only specified parameters are the benefits received each year in the payment phase. However, such promises also meet the definition of contribution-based (as discussed in the next section). The Board was unable to reach a conclusion on the classification. If guaranteed fixed returns were classified as defined benefit, then it would be clear that promises that fix the benefit amount (ie define the benefit) are defined benefit. Such promises are discussed further in paragraphs 21-26 below.

23. The staff shares some of the concerns noted above. However, the staff notes that it would be much easier for the Board to restrict the scope of contribution-based promises later in phase 1 than to extend it. The staff therefore recommends that in the Discussion Paper the scope of contribution-based promises should include promises with a guaranteed fixed return.

Classification of promises of a regular fixed amount after retirement

24. Chapter 5 (paragraphs 146-151) of the first preballot draft contained a section on “Types of promises on which the Board has not reached a preliminary view”. In accordance with directions given to the staff at the October meeting, that section explained that the Board did not intend to express a preliminary view on promises of regular payments of a specified amount after retirement. An example of such a promise is Promise 13 in the discussion paper:

Promise 13 The employer promises a benefit of CU1,000 per year for each year after the employee retires until his death, regardless of the service period of the employee.

25. No preliminary view was expressed because:

(a) some Board members argued that Promise 13 appears to be defined benefit because it is not expressed in terms of the accumulation of contributions and a promised return, and because the only specified parameters are the benefits received each year in the payment phase.

(b) others argued that Promise 13 is identical to other promises that meet the definition of a contribution-based promise, for example Promise 12.

Promise 12 The employer promises to contribute CU100,000 into a separate fund on the first year of service. The lump sum at retirement is the contribution of CU100,000, with a fixed return of 0%. The lump sum is converted into a pension at a guaranteed annuity rate that generates a benefit of CU1,000 per year for the life of the retiree.[1]

Promise 12 meets the definition of a contribution-based promise because it can be expressed as a single contribution of CU100,000 and a promised return of 0% plus whatever is need to achieve the guaranteed annuity conversion rate. Promise 13 is identical, and so could also be expressed in those terms.

26. In their comments on the first preballot draft, some Board members stated that it was inappropriate for the Board not to express a preliminary view on whether promises such as promise 13 meet the definition of a contribution-based promise. They argue that it is clearly contribution-based.

27. Further, paragraph 126 of the discussion paper argues that the accounting for post-employment benefit promises should not depend on how the employer describes the promise. The discussion paper concludes that Promise 12 meets the definition of a contribution-based promise, and that Promise 12 is identical to Promise 13, thus Promise 13 must also meet the definition of a contribution-based promise.

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[1] Promise 12 meets the definition of a contribution-based promise because it includes a guaranteed annuity conversion rate applied to a lump sum accumulated through a single contribution of CU100,000 and a promised return of 0%.

28. The staff therefore recommends that the Board explicitly states how promise 13 is classified as follows:

    (a) as a contribution-based promise, if the Board retains the classification of promises of fixed return as contribution-based; or

    (b) as a defined benefit promise if the Board classifies promises of fixed return as defined benefit.

Classification of promises that IAS 19 classifies as defined contribution

29. The proposed definition for contribution-based promises includes benefit promises that IAS 19 classifies as defined contribution.

30. During its deliberations, the Board noted that defined contribution promises are a subset of contribution-based promises and therefore that they should be combined.

31. An example of a defined contribution promise that would meet the definition of contribution-based is:

    The employer promises to make contributions of 5% of the employee's current salary into a separate fund for each year of service. The benefit promise at retirement is a lump sum equal to the contributions paid combined with the actual investment returns on those contributions.

32. An example of a more typical contribution-based promise is as follows:

    The employer promises to pay contributions of 5% of the employee's current salary into a fund for each year of service. The benefit promise at retirement is a lump sum equal to the contributions increased with compound interest at the rate of each year's return on a specified equity index.

33. The only difference between the defined contribution and contribution-based promises above is that, for a defined contribution promise, the entity has no further obligation once the contributions are paid, whereas for a contribution-based promise, the entity has an obligation for a promised return. The Board decided that, since defined contribution promises are simply a special case of contribution-based promises, there was no need to have two separate categories of benefit promises.

34. One Board member has questioned whether this is the best approach. Including defined contribution promises in the contribution-based category effectively changes the accounting for traditional defined contribution promises, even though the current IAS 19 accounting is straightforward and largely unproblematic in practice.

35. However, the staff notes that the accounting for defined contribution promises may not be as straightforward as first appears. For instance, there is some confusion as to whether IAS 19 allows defined contribution promises to be unfunded or for there to be a delay in the payment of the contributions. If a delay is allowed then it would be difficult to determine where the line should be drawn in order to determine whether a promise is defined contribution or contribution-based.

36. Also, depending on where that line is drawn such an approach could lead to a promise being categorised as defined contribution for a period of time, then contribution-based if the contributions are late, and then defined contribution again once the contributions have been paid.

37. If such promises were instead categorised as defined as contribution-based, the delayed payment of contributions introduces a promised return element into promise and the valuation of the liability would include the extent of the payment delay and the promised return. There would be no need to categorise a promise depending on when the employer pays the contributions, or to create an arbitrary rule that sets the period of time within which the contributions must be payable in order for it to be defined contribution.

38. Such an approach would mean that there would be no change in the accounting for typical ‘plain vanilla’ former defined contribution promise where the contributions are paid when they are due. For other defined contribution promises, the measurement of the unpaid contributions would change from present value to fair value assuming the benefit promise is unchanged.

39. Both the SAC and ARG have urged the IASB to endeavour to reduce the number of benefit categories as far as possible. Including defined contribution promises in contribution-based promises would help to serve this aim.

40. Therefore the staff recommends that the two benefit promises are combined, ie that the scope of contribution-based promises should include defined contributions plans as currently defined in IAS 19.

Disaggregation and presentation of changes in contribution-based promises

41. Chapter 9 of the preballot draft included the preliminary views that:
    (a) changes in the value of the liability for a contribution-based promise should be disaggregated into a service cost and other value changes (paragraph 230 of the preballot draft).
    (b) all changes in the value of the liability for a contribution-based promise and all changes in any plan assets should be presented in profit or loss (paragraph 233 of the preballot draft).
42. Question 10 of the Invitation to Comment asks “Do you have any comments on those conclusions?”
43. One Board member disagrees with those preliminary views. That Board member argues that:
    (a) the Board has not yet come to a preliminary view on the best presentation approach for defined benefit promises. Therefore it is inappropriate to be so conclusive about its decisions on contribution-based promises.
    (b) the Board has not made convincing arguments for not disaggregating changes in the value of a contribution-based promise. In particular, it has not justified the decision not to identify an interest cost for contribution-based promise liabilities, in contrast to the treatment for debt financial instruments and other obligations such as asset retirement obligations. The features of a contribution-based promise do not negate the benefit of disclosing an interest cost. Although not directly observable, interest cost could be calculated using the risk free rate irrespective of what the linked index or asset is. For instance, some liabilities could be bifurcated into a fixed rate obligation plus an equity swap. Interest accrues on the obligation and the equity swap is treated in the same manner as any other derivative.
    (c) there should be as much consistency as possible between the presentation of contribution-based and defined benefit promises. This would avoid extreme differences in the presentation of information for promises on either side of

the “bright line” that the Board has drawn between contribution-based and defined benefit promises. In particular, many consider career average promises and final salary promises to be economically similar, and consistency in presentation would minimise the effects of the Board’s decisions regarding classification.

44. The decisions about disaggregation and presentation of contribution-based promises were not discussed in detail by the Board during its decision-making sessions. Those decisions applied a logical extension of the following assumptions:

    (a) contribution-based promises are “derivative-like” in nature, ie they include guarantees or options

    (b) many interrelated assumptions are used in determining the fair value of a liability. Accordingly, any division between interest cost and other fair value changes would be difficult to achieve in an objective way, and would invariably suffer from arbitrariness.

    (c) information about disaggregation of changes in fair value is not useful to users of financial statements.

45. However:

    (a) the classification of promises of a fixed return as contribution-based mean that many contribution-based promises do not include options or guarantees.

    (b) the discussion paper argues elsewhere that inherent difficulties in measurement is not sufficient justification for not identifying items to be recognised in the financial statements. A similar argument could be made for disaggregation for presentation purposes.

    (c) the conclusion about the usefulness of disaggregation of changes in fair value was specific to certain financial instrument transactions and may not be applicable to post-employment benefit liabilities.

46. Accordingly, the staff recommends:

    (a) the discussion paper is redrafted to:

        (i) be less definite about the Board’s preliminary view on disaggregation and presentation for contribution-based promises.

(ii) spell out the differences in presentation between contribution-based and defined benefit promises that result from those preliminary views.

(b) the question in the Invitation to Comment seeks views on:

(i) how difficult it would be to disaggregate changes in the contribution-based promise liability into components similar to those required for defined benefit promises.

(ii) whether disaggregation of information about changes in the liability for contribution-based promises is useful, and what level of disaggregation should be required.

(iii) whether the presentation of changes in the liability for contribution-based promises should mirror the presentation of changes in the liability for defined benefit promises.

Tone of the chapter on presentation approaches, in particular for approach 3

47. Chapter 3 of the discussion paper looks at the presentation of the components of a defined benefit cost. It includes three approaches:

(a) Approach 1: All changes in the defined benefit obligation and in the value of plan assets are presented in profit or loss in the period in which they are incurred.

(b) Approach 2: The costs of service are presented in profit or loss. All other costs are reported as consequences of deferring payment of employee remuneration.

(c) Approach 3: The changes that arise from remeasurements relating to financial assumptions are presented outside profit or loss. Remeasurements relating to financial assumptions arise from changes in the discount rate and in the value of the plan assets. Changes in the amount of post-employment benefit cost other than those arising from remeasurement of financial assumptions, eg the costs of service, interest cost and interest income, would be recognised in profit or loss.

48. The Board instructed the staff to present the three approaches in a neutral manner, without expressing a preliminary view as to which approach the Board

supported. Some Board members have expressed concern that the discussion of approach three is too negative.

49. Approach three requires the identification of interest income on plan assets, which would be presented in profit or loss along with interest expense on the plan liabilities. This requires disaggregation of changes in the fair value of the plan assets. The pre-ballot draft discusses disaggregation of such changes in value as follows:

> Interviews relating to financial instruments indicate that many users do not find information about disaggregation of changes in the fair value of assets to be decision-useful. Approaches 1 and 2 do not require any disaggregation of changes in the fair value of assets.

50. A Board member argues:

> [Quote omitted from observer notes]

51. The three approaches to identifying an interest income amount are:
    (a) using the dividends received on equity plan assets and interest earned on debt plan assets using the current rate inherent in fair value;
    (b) using an imputed interest income determined using the discount rate determined by reference to market yields at the reporting date on high quality corporate bonds; and
    (c) using the expected return on assets, currently required by IAS 19.

52. Additional arguments in favour of (b) and (c) have been put forward by a Board member.

53. In respect of (b), the pre-ballot draft states:

> Imputed interest is an arbitrary method of estimating a return on assets. If this measure is not to suffer from the subjectivity of the expected return on assets in IAS 19, it would require the Board to specify the discount rate used to impute the interest income. The Board proposes the discount rate determined by reference to market yields at the reporting date on high quality corporate bonds. However, interest income computed in this way will not reflect the economic interest on plan assets unless the assets are invested in high quality corporate bonds.

54. A Board member argues:

[Quote omitted from observer notes]

55. In respect of the expected return on assets, ((c) above), the pre-ballot draft states:

> The Board has decided to eliminate the requirement to calculate and present in profit or loss an expected return on assets for the reasons given in Chapter 2.

> Chapter two states:

> The Board's financial instruments research indicates that other users do not find information about disaggregation of changes in fair value of assets to be decision-useful. Further, the subjectivity inherent in determining the expected rate of return provides entities with an opportunity to choose a rate with a view to manipulating profit or loss. This has resulted in large differences between expected and actual returns on assets.

56. A Board member argues:

[Quote omitted from observer notes]

57. In light of these comments, the staff proposes that:

    (a) The preliminary view that there should be no expected return on plans assets should be removed from chapter 2. The preliminary view in chapter 2 that no gains and losses should be deferred would remain, and the staff will if necessary amend the drafting to make it clear that this preliminary view covers gains and losses on plan assets as well as gains and losses on plan liabilities. But the question of whether the change in the fair value of plan assets should be disaggregated into an expected return and other gain or loss is a presentation issue that is better discussed in chapter 3.

    (b) The discussion of disaggregation of changes in fair value in chapter 3 is made less definitive, noting that some users do find the information useful.

    (c) The arguments noted above in favour of imputed interest and an expected return are included in the Discussion Paper and the comment that none of the three methods of identifying an interest income amount are satisfactory is deleted.