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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: 19 July 2007, London

Project: Post-employment benefits

Subject: Components of a defined return promise and their measurement (Agenda paper 7E)

Introduction

1. The Board has defined a defined return promise as having two components, comprising:
 - (a) a contribution requirement based on current salary; and
 - (b) a promised return on the specified contributions that is linked to the change in an asset or index.
2. This paper:
 - (a) gives a further analysis of the components of a defined return promise
 - (b) raises questions about whether performance risk should be included in the measurement of a defined return promise and
 - (c) considers the measurement of the benefit in payment.

Staff recommendation

3. The staff recommends:
 - (a) the contribution requirement should include both paid and unpaid contributions, with any payments being recognised as plan assets
 - (b) the components should be measured as follows:
 - (i) for the contribution component, a method based on the specified contributions and the IAS 19 discount rate (see Agenda Paper 7F)
 - (ii) for the return component, fair value under the assumption that the benefits for past service will not change and
 - (c) the liability for benefits in payment should be measured using the projected unit credit method discounted at the IAS 19 discount rate.
4. [Paragraph not reproduced in observer notes.]

The components of a defined return promise

5. The current proposal is that the liability for the contribution requirement should be based only on *unpaid* contributions. The assumption is that if the contributions have been paid, the liability for that component has been settled. But that may not be the case. Consider a promise for a contribution of 1000 and a return of 6%. Assume the contribution of 1000 was paid in the year it was earned, but then the plan assets in which was invested fell in value to 800. The entity has a liability not just for the return of 6% on the contribution of 1000, but also for the 200 needed to restore the contribution.
6. The staff argues that only way to ensure that the liability for the contribution requirement is always complete, whatever the funding of the plan, is to consider the plan liabilities and plan assets separately. The entity then recognises a net asset or liability which combines the two. So, in the above example, the plan liability is the contribution of 1000 and a return of 6%. The fact that the contribution has been paid to the plan is reflected in the existence of plan asset, with a value of 800.¹

¹ This is similar to the approach to measurement described as the “DB approach” in Agenda Paper 10A of the May meeting.

Measurement of the components of a defined return promise

7. In previous meetings, the Board has come to the following tentative decisions for the measurement of each component:
 - (a) the contribution component is measured using a present value that includes the time value of money. The Board asked the staff to develop a way of doing this.
 - (b) the promised return component is measured at fair value.
8. The staff notes that measuring both the components at fair value would be the most principled approach. Specifying a measurement objective rather than a methodology should, in theory, give more useful information. Consistent measurement for all components of a defined return promise must also be desirable.
9. However, at the June meeting, some Board members expressed concern over the use of fair value for pension promises. They argue that the effect of performance risk on fair value has yet to be fully discussed.

Performance risk

10. Performance risk is the risk that an entity will default on its obligation. It includes both:
 - (a) the possibility that an entity will not be able to meet its obligations (credit risk); and
 - (b) the possibility that an entity will choose not to meet its obligation.

The staff notes that it may not always be possible to distinguish between credit risk and other performance risk.

11. In the past, some entities have reduced pension benefits, including vested benefits and benefits in payment. Under existing IAS 19, the possibility of future reductions in benefits is not permitted to be included in the measurement of the pension promise.
12. [Paragraph not reproduced in observer notes.]
13. [Paragraph not reproduced in observer notes.]

14. Whether fair value reflects performance risk is an unresolved question in IFRSs. The staff argues that the general question cannot be resolved in this project. However, the staff argues that the Discussion Paper should address the issue of whether performance risk should be included in the measurement of defined return promises. A discussion of the issue for each component follows.

The contribution component

15. Three methods of including the time value of money in the measurement of the contribution component were raised at the June Board meeting:
- (a) require measurement of the contributions at fair value;
 - (b) specify a discount rate to be applied to the contributions; and
 - (c) a method suggested by a Board member, that would leave the contributions at their nominal amount.
16. The staff has noted above that measuring all components of the defined return promise at fair value would be the most principled approach. In June, the staff argued that the benefits of such an approach outweighed the benefits of the Board's previous decision that it did not want to include credit risk in the measurement of the contribution component. However, given the questions on other performance risk that the use of fair value may cause, the staff no longer recommends the use of fair value. Instead, the staff recommends a measurement method based on the contributions specified by the terms of the plan and the IAS 19 discount rate. Both approaches (b) and (c) do that. The choice between those approaches is discussed in Agenda Paper 7F.

The promised return component

17. The Board has previously decided that the promised return component should be measured at fair value. However, an entity can reduce the benefit of a promised return just as easily as reducing the promised contributions, so the difficulties associated with performance risk apply also to the promised return component.
18. However, unlike the contribution component, we cannot propose that the return component should be measured using a method that involves discounting at the IAS 19 discount rate. Consider a promise in which the promised return is the return on an equity index. Trying to apply the IAS 19 discount rate to that return is

one of the main issues that causes problems with defined return plans under the existing IAS 19. Any present value method that is not fair value needs to specify the discount rate to be applied in some way. Because of the difficulties in doing that, the staff argues that fair value is still the best starting point for the measurement of the return component.

19. Given this, the staff has identified three options for the return component:
 - (a) require the use of fair value and remain silent on the question of performance risk
 - (b) require the use of fair value and specify that it includes the effect of performance risk
 - (c) require the use of fair value under the assumption that the benefits will not change.
20. The staff does not think we should remain silent on the question of performance risk. It is an issue that should be discussed and on which the Board should ultimately have clear requirements. The staff also does not think it is possible to specify that fair value includes the effect of performance risk. To do so would be premature in advance of further discussions on the issue in the fair value measurement project. Before the issue is resolved in that arena, the staff recommends that the Board should specify that the required measurement for the return component is fair value *under the assumption that the benefits for past service will not change*.

Benefits in payment

21. In deciding how to measure a defined return promise, the staff argues that the benefit in payment needs to be considered separately from the benefits during the accumulation phase, as explained below.
22. In most post-employment benefit arrangements, the employer defers payment of part of the employee's remuneration until after the employee retires. Thus, the promises made to employees could be viewed as having two distinct phases:
 - (a) an accumulation phase during which the employee renders service in exchange for the promise of remuneration in the future. This phase ends when the employee retires or leaves service.

(b) a payout phase after the employee retires, during which the employer's liability to the employee for previously deferred remuneration is settled.

23. In Agenda Paper 7B, the staff proposes definitions of defined contribution, defined return and defined benefit. These definitions focus on the way in which the benefit to the employee accumulates during his service life. For a defined return promise, the employee accumulates benefit through the promise of contributions and a specified return on those contributions.

24. After retirement, the employer settles its liability to the employee. It may do this in one of the following ways:

(a) payment of a lump sum to the employee. For defined return promises, the lump sum comprises the contributions and the returns on those contributions up to the date of retirement.

(b) purchase of an annuity (eg from an insurance company) that settles the employer's liability to make annual payments every year until the employee's death. From the employer's point of view, this is economically the same as in (a) above.

(c) annual payments every year until the employee's death (an annuity). Those annual payments could be:

(i) based on market annuity rates at the date of the employee's retirement or

(ii) based on an annuity rate other than market rate at the date of the employee's retirement.

25. If an employer settles its obligation through a lump sum payment or the purchase of an annuity, the employer extinguishes its liability and has nothing left to account for. In contrast, if the employer is obliged to make a stream of annual payments to the employee (and does not settle its obligation through the purchase of an annuity), the employer has an on-going liability to account for.

26. The staff argues that there is little benefit to continuing to track the two components of the defined return promise, the contribution component and the return component, once the benefit is in payment. The staff thinks that to do so would add complexity to the accounting for little benefit. Instead the benefit in payment should be considered as a single item. This means that we need to consider how that single item should be measured.

27. The staff notes that the same obligation at retirement could arise from different methods of accumulation. For example:

Plan A is a defined return plan in which the contributions plus the investment returns are converted to an annuity at a guaranteed rate. The employer retains the obligation to make the annual payments to the employee. In this example, the employee is entitled to receive CU100 per annum after retirement.

Plan B is a defined benefit plan in which the employee is entitled to annual payments of 50% of his final salary after retirement. The employee's final salary is CU200. Thus, the employee is entitled to receive CU100 per annum after retirement.

28. In both Plan A and Plan B, the employer's obligation is to pay CU100 per annum every year until the employee dies. If the employees have the same life expectancy, one might expect the payout liabilities for the two employees to be exactly the same. However, during the accumulation phase, the employer would have recognised the liability in Plan B using the projected unit credit method. Unless the Board requires that defined return promises in payment are also measured using the projected unit credit method, the liability recognised by the employer at retirement may be different for plan A and plan B. This does not seem desirable.

29. The staff therefore recommends that the benefit in the pay out phase of a defined benefit return should be measured using the projected unit credit method, consistent with the same benefits in the payout phase of a defined benefit plan.

30. The staff acknowledges that this approach could lead to a gain or loss arising on the plan liabilities on retirement because of the change in measurement attribute. However, the staff notes that most defined return promises will be settled at retirement by a lump sum payout or the purchase of an annuity. One of the reasons for entities moving to defined return promises is to avoid the longevity risks inherent in the promise of an annuity. So the choice of a measurement attribute for the pay out phase will affect relatively few promises.