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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:	**20 June 2007, London**
Project:	**Post-employment benefits**
Subject:	**Measurement of the contribution liability (Agenda paper 6C)**

1. The objective of this paper is to clarify the measurement of the employer's liability for the contribution requirement in a defined return promise.

Background

2. At the May meeting, the Board concluded that *defined return* promises (DR promises) are comprised of two components: a contribution requirement and a promised return on those contributions. The Board tentatively agreed that the measurement of the balance sheet liability in respect of each component would be as follows:

   (i) contribution requirement – the amount of any unpaid contributions

   (ii) promised return - the fair value of the guaranteed return less any plan assets available to satisfy that liability

3. However, one Board member pointed out that measurement of the two components is inconsistent because it makes no allowance for the time value of money for the contribution requirement but makes an allowance for the time value of money for the promised return on those contributions.

4. The Board discussed and rejected the possibility of measuring the contribution requirement at fair value. But the staff thinks that discussion did not fully consider the effect of the time value of money on contributions that will not be paid for a long period of time, for example notional contributions to an unfunded plan. The focus of that discussion was that the contribution requirement in a DR promise is the same as the contribution in a DC promise – the only difference between DR and DC promises is the defined return element. But an important distinction is that the contributions in a DC promise must be paid relatively soon after the period to which they relate. Otherwise there would be requirements in the plan rules about the return on the unpaid contributions, making the promise a defined return promise. But in defined return promise, the contributions may not be payable for a considerable time after the period to which they relate. In an unfunded defined return promise, the contribution requirement will not be payable until the benefit itself is payable.

5. This paper considers whether an allowance for the time value of money in should be made in measuring the liability for the contribution requirement.

Staff Recommendation

6. The staff recommends that the employer is required to measure the liability for both the contribution requirement and the promised return in a DR promise at fair value.

7. The staff also recommends that no change is made to the measurement of the employer’s liability for the contribution requirement in a defined contribution (DC) promise. This liability would continue to be measured at the sum of the unpaid contributions.

Allowing for the time value of money

8. The rationale for measuring the liability for the contribution requirement in a DR promise at the sum of any unpaid contributions was as follows. The contribution requirement in a DR promise is the same as the contribution requirement in a DC promise. The employer's liability in respect of unpaid contributions in a DC promise is measured at the sum of any unpaid contributions. Therefore, for consistency, the liability for the contribution requirement in a DR promise should be measured at the sum of the unpaid contributions.

9. However, as mentioned above, one Board member pointed out the inconsistency of such an approach with a fair value measurement for the defined return component. The approach is equivalent to measuring at fair value the interest only portion of a loan payable whilst measuring the principal only portion at an amount that does not include the time value of money.

10. For example consider an employer liability to pay 100 plus interest at 6% in 5 years' time. The employer liability would be derived as follows[1].

	Nominal amount	Present value
Principal	100	75
Interest	34	25
Total	134	100

11. In this case, both the principal amount of 100 and the interest earned are discounted.

12. Now, consider the following plan:

> The benefit promise at retirement is a lump sum equal to a notional contribution of 100 plus guaranteed fixed returns of 6% per year. For simplicity, assume there is only one year's contribution and the employee will retire in five years' time.

[1] For simplicity, factors that would affect fair value other than the time value of money are ignored at this point. They are considered later in the paper.

13. In this case the employer’s obligation is the same as in the example above, however the measurement of the liability under the proposals from the last meeting would be very different. The reason for this is that the contribution requirement (principal) is measured at the sum of unpaid contributions instead of at a discounted present value. The employer liability would be the nominal amount of the contribution of 100 plus the present value of the defined return of 6%, 25, being 125.

14. This approach is internally inconsistent because it discounts the interest earned (the promised return) but not the principal amount (the contribution requirement). A conceptually better approach would require the measurement of both the contribution requirement and the promised return at their discounted present value, thus making an allowance for the time value of money consistently.

15. The staff notes the Board’s intention to maintain consistency with the measurement of the contribution requirement in a DC promise. However, the period over which the contributions can be unpaid in a DC promise must be very short (otherwise the promise would not be DC, it would be DR). As a result, the difference between the discounted present value of unpaid contributions and the sum of the unpaid contributions would be very small.

16. Therefore the staff thinks that there is very little difference in practice between the employer measuring the liability for the contribution requirement in a DC promise at its discounted present value or at the sum of the unpaid contributions. The Board could decide to amend the requirement for DC promises in IAS 19 so that they too are discounted. However, the Board has decided not to change the measurement for DC promises in phase I of the project and the suggested change could be misunderstood as introducing added complexity to the accounting for DC promises. Therefore the staff recommends that no change is made to the measurement requirements for a DC promise.

17. However, for a defined return promise, there may be a very long period of time before the contributions are required to be paid. In particular, some defined return promises are wholly unfunded, so that the contribution will not be paid until the date the benefit becomes payable. In this case there would be a significant

difference between the discounted present value of any unpaid contributions and the sum of those contributions.

18. Discounting is an accepted feature of accounting for defined benefits and other long-term employment benefits. The staff argues that not doing so for the contribution requirement in a DR promise would be a retrograde step. The staff therefore recommends that the measurement of the contribution requirement should include the effect of the time value of money.

Present value or fair value

19. The question then arises of how the time value of money should be included. The staff has identified two options:

    (a) specify a discount rate to be used, or

    (b) require measurement of the contribution at fair value.

20. As noted above, the Board considered and rejected measurement at fair value in May. Further, we could use the discount rate already specified in IAS 19, a high quality corporate bond rate, as the discount rate to calculate the present value of the contributions. Doing this would avoid potentially lengthy debates on what the appropriate discount rate should be.

21. However, the staff thinks the Board rejected measurement at fair value before the question of the time value of money had been fully considered, in particular in relation to unfunded promises. If the Board accepts the staff recommendation that the time value of money is included in the measurement, the choice is between fair value and a present value calculated using a specified discount rate. And fair value is already being used for the promised return on the contributions.

22. The staff is aware of the need to avoid undue complexity in the proposals for DR plans. However, the staff argues that including the time value of money in the measurement of the unpaid contributions is necessary to avoid substantial overstatement of the liabilities in unfunded plans. A measurement objective of fair value is a relatively straight forward way of achieving this. For plans in which the contributions are paid sooner after the period to which the contributions

relate, there will be little difference between the fair value and the nominal value of the unpaid contributions.

23. On balance, the staff therefore recommends that the liability for unpaid contributions should also be measured at fair value.