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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:	**Components of the defined return cost (Agenda paper 6E)**

1. The objective of this paper is to determine whether and how the change in a defined benefit return promise should be disaggregated, and how it should be presented in profit or loss and other comprehensive income.

Background

2. At the May meeting, the Board agreed that there are three types of post-employment promises: *defined benefit (DB), defined contribution (DC)* and *defined return (DR).*

3. The components of profit and loss and other comprehensive income for DB and DC promises are determined in accordance with the current IAS 19 requirements for DB and DC plans respectively.

4. DR promises are a newly identified category of promises. The Board has not yet decided how change in value of defined return promises should be disaggregated and presented.

Staff Recommendation

5. DR promises are comprised of two components: a contribution requirement and a promised return on those contributions. The staff recommends that the change in the liability for the DR promise is disaggregated as follows:

    service cost being the initial recognition of the liability for the contributions payable for the year plus the initial fair value of the promised return on those contributions

    fair value gain/loss arising on the subsequent remeasurement of the liabilities.

   Both components should be presented in profit or loss, as should all changes in value of any assets funding defined return promises.

Disaggregation

6. To determine whether and how changes in a defined return promise should be disaggregated, the staff considered the existing disaggregation requirements in IAS 19 for DC promises and DB promises.

The DC Model

7. IAS 19 requires no disaggregation for DC promises. The contribution payable for the period is presented as a single expense and there is no remeasurement. Following that approach for DR promises indicates that the contribution component should not be disaggregated on initial recognition.

8. Further, research conducted by the financial instruments working group indicates that many users do not find disaggregation of remeasurements at fair value to be decision-useful. But that still leaves the question of whether there is informational value in disaggregating the *initial recognition* of the contribution and defined return requirements from subsequent changes arising on *remeasurement*.

The DB model

9. The defined benefit cost under IAS 19 disaggregates the change in a defined benefit liability into the service cost, interest cost and actuarial gains and losses components of the benefit promise.

   - *Service Cost*

10. IAS 19 requires the service cost to be calculated as the *increase in the present value of the defined benefit obligation resulting from employee service in the current period.*

11. For a DB promise that provides, say, 2% of final salary per year of service, the service cost in each year is the present value of the entity's obligation for 2% of estimated final salary.

12. For the DR promise, the increase resulting from employee service in the period is the initial recognition of the liability for the contributions payable in that period plus the initial fair value of the promised return on those contributions. This would be consistent with disaggregating initial recognition amounts from subsequent remeasurements under the DC model.

13. The next question is whether it is worth splitting the subsequent changes in fair value into an interest cost and actuarial gains and losses.

   - *Interest Cost*

14. The interest cost represents the increase in the present value of the employer's obligation, which arises because the benefits are one period closer to settlement. This interest cost component assumes a project and discount approach to valuing the defined benefit obligation for a defined benefit promise.

15. The equivalent of interest cost in a DR promise could be calculated based on the discount rate used to calculate the fair value of the liability at the beginning of the year. However, the input factors for valuing the liability are strongly interdependent and it could be very complicated to isolate the effect of time on the value of the promise from the other factors.

16. In particular, if the defined return promise includes optionality, the concept of an interest cost could only be applied in an artificial way. Further, the effect of the passage of time would usually be small compared with other factors such as the change in price and volatility of the promise.

Actuarial/Fair value gains and losses

17. Actuarial gains or losses include the cumulative amounts of the gains and losses on the defined benefit obligation as a result of experience adjustments and changes in the actuarial assumptions.

18. For a DR promise, changes in fair value may be caused by many factors including changes in (1) market factors (such as risk-free interest rates), (2) cash receipts and payments, (3) changes in credit quality, (4) the passage of time, (5) demographic experience and (6) estimation methods or valuation models.

19. Quantification of the effects on fair values of some of those factors may be very difficult to achieve in an objective way. Further, as noted above, research indicates that many users do not find information about disaggregation of changes in the fair value to be decision-useful.

20. The staff therefore thinks that the disaggregation of the change in fair value of the liability into separate components would add unnecessary complexity without the benefit of providing additional decision-useful information.

21. The staff therefore recommends that the components of a DR cost should be:

    (a) **service cost** arising on the initial recognition of the fair value of the liability for the contributions payable in the year and the fair value of the promised return on those contributions and

    (b) **fair value gain/loss** arising on the remeasurement of the liabilities.

Presentation

22. Whenever the presentation of post-employment benefits costs has been considered, service cost has always been presented in profit or loss. The staff recommends that should also be the case for the service cost for DR promises.

23. In relation to the subsequent changes in fair value, the staff notes the following precedents:

    (a) under approach one on the presentation of defined benefit plans in the Discussion Paper, all changes in the defined benefit obligation are presented in profit or loss

    (b) under approach two on the presentation of defined benefit plans in the Discussion Paper, the service cost and changes in its estimate are presented in profit or loss. The interest cost and changes arising from changes in the discount rate are presented in other comprehensive income.

    (c) under approach three on the presentation of defined benefit plans in the Discussion Paper, the service cost, changes in its estimate and the interest cost are presented in profit or loss. The interest cost and changes arising from changes in the discount rate are presented in other comprehensive income.

    (d) changes in financial liabilities measured at fair value under IAS 39 are presented in profit or loss.

24. The staff notes that (b) and (c) above require greater disaggregation than the staff recommendation. Further, the thinking underlying the definition of DR promises is that they are like DC promises with a financial guarantee. The staff argues that it is therefore appropriate to present the remeasurements in fair value consistently with the treatment of changes in the fair value of other financial liabilities, ie in profit or loss.

25. The staff further argues that, if all the changes in the liabilities under a defined return promise are recognised in profit or loss, to be consistent all changes in any assets funding such a promise should also be recognised in profit or loss.