



30 Cannon Street, London EC4M 6XH, United Kingdom  
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411  
Email: [iasb@iasb.org](mailto:iasb@iasb.org) Website: [www.iasb.org](http://www.iasb.org)

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 September 2007, London

**Project:** IAS 19 *Employee Benefits*

**Subject:** Measurement of the liability  
for the defined return promise  
(Agenda paper 6B)

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## Introduction

1. In Paper 6A, the staff proposes the following definition for defined return promises:

*A defined return promise is a post-employment benefit accumulated through a contribution amount which, for any given period, can be expressed independently of the salary that will be earned after the end of that period.*

For some *defined return* promises the entity may have an obligation for the promised return on the contribution amount. The promised return is a guaranteed fixed return, the change in the value of an asset, or group of assets, the change in value of an index, or any combination of these.

2. Based on previous decisions made by the Board, the staff has identified three possible approaches for accounting for the defined return promise and would like to ask the Board which of these approaches it wishes to include in the Discussion Paper.

## Staff recommendation

3. The staff recommends that the employer's liability for the contribution requirement and the promised return in defined return promise should be measured at fair value assuming the benefit promise does not change.

## The three approaches

4. An example of a defined return promise is as follows:

### Plan 1

An employer promises to pay in five years' time a lump sum of a contribution of 1000 plus a return of 6% per year to its employees.

5. The Board noted previously that the risk in the promised return of a defined return promise is a financial risk. As the proposed definition states, the promised return could be a guaranteed fixed return or a return linked to an asset available on the open market (eg returns on the FTSE 100 equity index). IAS 19 requires that entities measure the defined benefit obligation for a benefit that depends on future returns by:
  - (a) projecting forward the benefit using its best estimate of the rate of return on the specified assets and
  - (b) then discounting that amount using a high quality corporate bond rate.
6. This would result in anomalous results when the return is linked to an asset available on the open market. Therefore, the Board tentatively decided that the employer's liability for the *promised return* should be measured at fair value.
7. However, the Board noted that it is not clear whether the allowance for performance risk in the fair value methodology includes the risk that the employer may change the benefit promises. The Board decided that the unit of account should be the benefit promise for which the entity has an obligation at the balance sheet date assuming no changes to the benefit promise are made. Therefore, the Board decided that the promised return should be measured at fair value assuming that benefit promise does not change. The Board noted that this assumes that it is possible to distinguish between a change in benefits and other performance risk,

such as credit risk. That is a question that will be discussed in the fair value measurement project. If those discussions indicate that such a distinction cannot be made, the staff will bring back to the Board the question of performance risk in the measurement of the defined return promise.

8. The Board also decided that the time value of money on the *contribution requirement* should be accounted for.
9. In accordance with this, the staff has identified three possible approaches for the measurement of the employer's liability for the two elements of the defined return promise. Throughout the rest of the paper, fair value is used assuming that the unit of account is the benefit promise as it exists at the balance sheet date, ie assuming that the benefits do not change.

	<b>Contribution Amount</b>	<b>Promised Return</b>
<b>Approach A</b>	Present value, using IAS 19 discount rate, of unpaid contributions	Fair value assuming the benefit promise does not change of the promised return
<b>Approach B</b>	Undiscounted accumulated value of unpaid contributions	Fair value (assuming the benefit promise does not change) of the difference between the promised return and the market rate of interest on contributions payable
<b>Approach C</b>	Fair value of unpaid contributions	Fair value assuming the benefit promise does not change of the promised return

10. A comparison of the three approaches as applied to Plan 1 above is set out in the appendix.
11. Approach A measures the liability for the contribution component differently from the liability for the promised return. The Board decided to consider such an approach because it wished to emphasise the similarity of the contribution

component with defined contribution promises. Under paragraph 45 of IAS 19, the employer's liability for unpaid contributions in a defined contribution plan is measured at the present value of any unpaid contributions, payable after 12 months, using the IAS 19 discount rate.

12. Approach B was suggested by a Board member as an attempt to achieve an overall fair value measure for the liability while maintaining consistency with the accounting for DC promises. In essence the time value of money on the contribution amount is shifted to the promised return component and the accumulated return to date is included in the contribution amount.

#### *Problems with Approaches A and B*

13. One Board member has pointed out that any approach that measures the employer's liability for the contribution amount differently from the promised return would lead to the same economic benefit being accounted for in different ways.

14. For example, consider the following two unfunded benefit promises:

- (a) a lump sum of 1,340 paid in 5 years' time (contribution amount of 1,340 plus a guaranteed fixed return of 0%); or
- (b) a lump sum of 1,000 with a guaranteed fixed return of 6% paid in 5 years' time (contribution amount of 1,000 plus a guaranteed fixed return of 6%).

15. These benefit promises are economically the same (an amount of £1,340 is payable in 5 years' time). However, if the contribution component is accounted for differently from the promised return the accounting results would be different. This could lead to opportunities for accounting arbitrage. As a result, the staff recommends that the contribution amount and the promised return should be accounted for in the same way.

#### *Approach C*

16. The Board has already decided that the promised return should be accounted for at fair value assuming that the benefit promises does not change. Therefore, the staff recommends that the employer's liability for the contribution amount should also be measured at fair value assuming the benefit promise does not change.

17. This would result in a change in the measurement of the employer's liability for unpaid contributions in a defined return promise from the Board's previous decision.
18. The difference between the present value of unpaid contributions using IAS 19 assumptions and the fair value of unpaid contributions would be due to the difference in discount rate. The difference in the discount rate arises because of differences between the IAS 19 discount rate and market risk-free rates of interest as well as the employer's credit risk.
19. The Board suggested previously that it did not wish to include the employer's own credit risk in the measurement of the contribution requirement for DR plans. Including the credit risk would imply that the less likely an employer is to make a contribution, the lower the employer's liability for the contributions payable. The staff agrees that this would be a controversial change from the current requirements of IAS 19, which do not include credit risk in the measurement of a defined benefit obligation. However, the definition of fair value applied to the measurement of financial instruments in IAS 39 includes the effect of credit risk. The staff does not think that it would be appropriate to attempt to develop a modified version of fair value that is specific to pensions in phase I of the project.
20. Further, credit risk is included in the measurement of the fair value of the promised return. The staff argues that the need for the same measurement of the two elements (as discussed above) is such that credit risk should also be included in the measurement of the contribution element.

#### *Allocation of the liability*

21. Approaches B and C measure the employer's liability for the entire defined return promise at fair value. However, Approach B puts the effect of the time value of money on the contribution amount in the liability for the promised return component and the effect of the accumulated past returns from the promised return component in the liability for the contribution requirement.
22. The staff notes that if approach B is followed, the contribution requirement in a DR promise would no longer be the same as the obligation arising under a DC promise, a similarity that the Board has been keen to stress. Therefore, the staff recommends Approach C.

**The staff recommends therefore that the Board requires the employer's liability for the contribution requirement in defined return promise to be measured at fair value assuming the benefit promise does not change and for the employer's liability for the promised return component to be measured at fair value assuming the benefit promise does not change. Does the Board agree with the staff recommendation?**

**Comparison of Approaches A, B and C**

1. Consider the example in Plan 1

**Plan 1**

An employer promises to pay in five years' time a lump sum of a contribution of 1000 plus a return of 6% per year to its employees.

The discount rate specified by IAS 19 at the balance sheet date is 5%.

2. When the contribution is first earned, before any returns have accumulated:
  - (a) Under approach (a), both the contribution amount and the return component are measured at a present value, ie discounted for 5 years at a rate of 5%.
  - (b) Under approach (b), the contribution amount is the undiscounted amount of the contributions and the return component is the present value of the incremental return compared to the IAS 19 discount rate.
  - (c) Under approach (c), the contribution amount and the promised return are measured at fair value. It is assumed that the fair value discount rate is the same as the IAS 19 discount rate in the first year.

	<b>Approach A</b>	<b>Approach B</b>	<b>Approach C</b>
<b>Contribution</b>	784 <sup>1</sup>	1000	784 <sup>2</sup>
<b>Return</b>	265 <sup>3</sup>	49 <sup>4</sup>	265 <sup>5</sup>
<b>Total</b>	1049	1049	1049

3. After one year, a return of 60 has accumulated and the market rate of interest has increased to 7%, the IAS 19 discount rate is still 5%.

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<sup>1</sup>  $1000/(1.05^5)$

<sup>2</sup>  $1000/(1.05^5)$

<sup>3</sup>  $((1000 \times 1.06^5) - 1000)/(1.05^5)$

<sup>4</sup>  $((1000 \times 1.06^5) - (1000 \times 1.05^5))/(1.05^5)$

<sup>5</sup>  $((1000 \times 1.06^5) - 1000)/(1.05^5)$

- (a) Under approach (a), both the contribution component and the return component are measured at a present value, ie discounted for 4 years at a rate of 5%.
- (b) Under approach (b), the contribution component is the undiscounted amount of the contributions plus the accumulated return and the return component is the present value of the incremental future return compared to the IAS 19 discount rate.
- (c) Under approach (c), the contribution amount and the promised return are measured at fair value, using a discount rate of 7%.

	<b>Approach A</b>	<b>Approach B</b>	<b>Approach C</b>
<b>Contribution</b>	823	1060	763
<b>Return</b>	278	(39)	258
<b>Total</b>	1101	1021	1021

4. Approach B effectively moves the time value of money on the contribution from the liability for the contribution requirement to the liability for the return component. It also moves the accumulated return from the return component to the contribution requirement. In other words Approach B measures the entire liability at fair value but attributes the liability to the contribution amount and the promised return differently