Project **Post-employment benefits**

Topic **Interest income on plan assets**

Purpose of this paper

1. At its November meeting, the Board decided to re-examine its conclusion that no interest income on plan assets is recognised in profit or loss and the entire return on plan assets is a remeasurement. This paper:
   (a) sets out the background that led to the Board's original conclusion
   (b) describes the net interest approach that the Board requested to consider in more detail
   (c) asks the Board to propose in the ED that entities calculate interest income on plan assets using an expected rate of return.
2. This paper does not consider from first principles all the possible approaches to the presentation of interest income on plan assets.

Background

3. The Board previously concluded (in February 2009) that the remeasurement component should include the total return on plan assets and actuarial gains and losses on the defined benefit obligation. In other words, the Board previously concluded entities should not recognise interest income on plan assets in profit or loss. (That decision does not prohibit entities from reporting interest income on plan assets separately within the remeasurement component.)
4. In arriving at its tentative conclusion, some Board members endorsed the principle that the change in value in any asset can be divided into a change that

arises from the passage of time and other changes. However, the Board found it difficult to find a practical way to distinguish interest income on plan assets from other changes in the value of plan assets, particularly for plan assets that do not bear explicit interest.

5. The Board rejected approximations to the effect of the passage of time using:

   (a) the expected return on plan assets (as currently required by IAS 19) because it could not be determined in an objective way.

   (b) dividends received on equity plan assets and interest earned on debt plan assets (using the current rate market participants would require for equivalent assets) because recognising only dividends on equity plan assets would result in entities recognising returns from dividend-paying equity investments separately from returns from non-dividend-paying equity investments. This would create an incentive for entities to invest in particular plan assets to achieve an accounting result, rather than for economic reasons.

   (c) market yields at the reporting date on high quality corporate bonds to calculate interest income on plan assets because those yields are not relevant for assets whose characteristics differ from those of such bonds.

6. The Board also considered requiring the total return on plan assets to be classified as interest income. The Board rejected that approach because it would be inconsistent with a previous decision to disaggregate the pension cost into service cost, financing cost and remeasurements.

Comments on the Board’s tentative conclusion

7. The Board’s tentative conclusion that entities should not recognise interest income on plan assets in profit or loss has the advantage that it does not require entities to make an arbitrary decision or subjective judgement on how to divide the return on plan assets into an interest component and a remeasurement.

8. However, we think that it has the disadvantages that there is nothing to offset the interest expense on the defined benefit obligation. Many believe an important economic characteristic of a funded plan is that the growth in the plan assets compensates for the growth in defined benefit obligation over time. If no interest income is recognised, there is no difference in the financing cost between entities with funded plans and those with unfunded plans.

Net interest approach

9. IAS 19 requires that a net defined benefit asset or liability is recognised in the statement of financial position. Some Board members propose that the entity recognises in profit or loss interest income that is determined with reference to the net defined benefit asset or liability (a 'net interest approach'), rather than separately determined with reference to the plan assets and defined benefit obligation. We describe two variants on that approach below.

10. Both variants of the net interest approach regard a net pension liability as an amount owed by the reporting entity to the fund or the employees. The economic cost of the financing represented by the net liability is interest expense, which is recognised in profit or loss.

11. Similarly, a net pension asset is an amount owed by the fund to the reporting entity. The reporting entity accounts for the present value of economic benefits it expects to get from the fund in the form of refunds or reductions in future contributions.

12. In the first variant, an entity would discount both net liabilities and net assets using a rate determined by reference to market yields on high quality corporate bonds. If there is no deep market in such bonds, the entity would use market yields on government bonds. This is consistent with paragraphs 58 and 78 of IAS 19.

13. An alternative way to describe this variant is to consider a funded plan as comprising a fully funded portion and an unfunded or overfunded portion. The

fully funded portion does not generate any interest income or expense. Any unfunded portion is similar to an unfunded plan, and the interest expense would be calculated using the rate specified in paragraph 78 of IAS 19. Any overfunded portion provide economic benefits to the entity in the form of refunds or reductions in future contributions. The entity discounts those economic benefits using the rate specified in paragraph 78 of IAS 19. Thus the net asset generates interest income, which is recognised in profit or loss.

14. In the second variant, an entity would determine, for presentation purposes, the interest cost on a net liability in the same way as it would for a liability within the scope of IAS 37. In other words, any net liability would be discounted using a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. As with variant 1, this approach would not change the measurement of the DBO or the plan assets. Thus, the entity would use the discount rate specified in paragraph 78 of IAS 19 to determine the net liability and then apply the IAS 37 discount rate to determine the interest income that is recognised in profit or loss. Any net asset (ie any overfunded portion) would be treated as if it were a beneficial interest that is measured at fair value. Thus, there would be no interest income on the net asset.

15. The rationale for a net interest approach is that it would be wrong to present separately movements on the underlying assets and liabilities that combine to make a net pension asset or liability, given that the entity recognises a net pension asset or liability. The net interest amount is consistent with the balance sheet position, ie surpluses produce interest income and deficits produce interest expense. Some users of financial statements state that the component of pension cost other than service cost with the greatest predictive value is the periodic interest income or expense arising from the time value of money or the unwinding of the discount implicit in the current value measure of the net pension asset or liability. The variants differ in the way that the net interest amount is determined.

16. However, in the staff's view, proposing a net interest approach at this stage has the following disadvantages:

    (a) both variants of the net interest approach implicitly treat the assets and liabilities in the fully funded portion as having the same interest rates even though they may often have different characteristics.

    (b) the Board would have to resolve some practical issues. For example, the yield curve means it matters **which** part of the DBO is treated as funded and which is treated as unfunded. The Board would need to decide whether and how to specify which part of the DBO is treated as fully funded.

17. In addition, we do not think that a net interest approach as described is consistent with finding a presentation approach that can be accommodated under the existing model in IAS 19. Although the basis of presentation in the statement of financial position under IAS 19 is that the entity has a net deficit or surplus, that surplus or deficit is determined by the combination of two items that generally have different economic drivers and are measured on different measurement bases. The plan assets are measured at fair value and the defined benefit obligation is measuring using the projected unit credit method. IAS 19 does not determine the net asset or liability directly. Given this, it is not possible to assess the net interest that would arise if the net asset or liability were measured directly.

18. We agree that the same result as variant 1 of the net interest approach could be achieved in the existing IAS 19 model by requiring that interest income on the plan assets is approximated using the rate used to discount the liabilities. However, requiring interest income on plan assets, which may be invested in many different ways, to be determined using a high quality corporate bond rate would not be a faithful representation of the returns that investors require or expect from such assets and would be arbitrary. The resulting interest income derived in this way would have economic meaning only if the plan assets happened to be invested in high quality corporate bonds.

19. We also agree that a net interest approach improves on the Board's tentative conclusion that the entire return on plan assets is a remeasurement because it results in amounts recognised in profit or loss that reflect the differences between funded and unfunded plans. However, we think that the Board should assess whether the approach also improves on the current position in IAS 19.

20. The current version of IAS 19 identifies a financing component in the change in plan assets using the expected return on assets. The Board previously rejected using the expected return on assets because of concerns over subjectivity and abuse. However:

    (a) in the staff's view, there is no benefit in replacing expected return on plan assets with an arbitrary measure of interest income on plan assets.

    (b) the comment letters, working group members and informal meetings with constituents tell us that the expected return, and historical deviations from the stated expected return, convey decision-useful information to users of financial statements. Those constituents acknowledged that there had been abuse in the past but suggested that the Board could address such abuse in other ways, eg improved disclosure of information such as sensitivities to changes in expected return and how the expected return was calculated and of historical comparisons of expected against actual return.

    (c) using expected return on plan assets reflects the different economic characteristics of the plan assets.

21. Accordingly, we do not think that, in the context of the current IAS 19 model (which determines a net defined benefit asset or liability as a combination of two items measured on different bases) a net interest approach is an improvement to the current position in IAS 19.

Question for Board
Does the Board agree to propose no change to the requirement in IAS 19 for entities to calculate and recognise in profit or loss an expected return on plan assets?

If not, which approach should be proposed in the ED:

(a) the total return on plan assets is a remeasurement and there is no interest income on plan assets

(b) interest should be determined by applying the high quality corporate bond rate to the net defined benefit asset or liability

(c) a net liability should be discounted using a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability, and a net asset should be treated as if it were a beneficial interest measured at the fair value?