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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**February 2009, London**
Project:	**Post-employment Benefits**
Subject:	**Defining the remeasurement component (Agenda paper 5A)**

Purpose of this paper

1. At its January meeting, the Board tentatively decided that entities should disaggregate changes in the defined benefit obligation and in plan assets into employment, financing and remeasurement components.

2. This paper asks the Board to define the remeasurement component.

3. Consistent with January's decision we have assumed that the remeasurement component is presented in the income statement. We will not discuss the detail of how the remeasurement component is presented at this meeting. We expect that Board members would prefer not to finalise their views on presentation of the remeasurement component until it is defined.

Summary of staff recommendations

4. The staff recommends that:

    a. the Board specifies what is included in the remeasurement component. (paragraph 13).

    b. changes in the plan liabilities caused by changes in all assumptions should be in the remeasurement component (paragraph 19).

c. changes in the plan assets should be disaggregated into a financing component (interest income) and a remeasurement component. (paragraph 25).

d. the Board require that interest income is calculated using the expected rate of return (paragraph 43).

Relationship to tech plan

5. The relationship to the tech plan is discussed in Agenda paper 5.

What happens if the Board does not reach agreement in this meeting

6. We think that the Board needs to finish discussions on this project by July 2009 in order to meet the timetable set out in agenda paper 5. This gives us some scope to continue discussions at future meetings.

7. However, if the discussion at this meeting suggests that a single view may not gain sufficient support in a reasonable time, then we will discuss at the next meeting:

   a. whether it is an appropriate use of resources to continue to try to define the remeasurement component; and

   b. if not, what options are available to the Board.

What is a remeasurement?

8. At its January meeting, the Board decided that the change in a post-employment benefit obligation should be disaggregated into employment, financing and remeasurement components.

9. IAS 19 divides pension cost into the following components:

   a. current service cost

   b. interest cost

   c. expected return on assets

   d. actuarial gains and losses (on both the benefit obligation and the plan assets)

   e. past service cost

   f. the effect of settlements and curtailments

   g. the effect of the asset ceiling.

10. We think that it is obvious that:

    a. current and past service cost would be part of the employment component; and

    b. interest cost would be part of the financing component.

11. We will consider how to classify the effect of settlements, curtailments and the asset ceiling at a later meeting. This paper considers which actuarial gains and losses on plan liabilities should be put into the remeasurement component and whether and how the change in plan assets should be disaggregated.

12. Specifying the definition of the remeasurement component is inconsistent with the management approach to classification described in the financial statement presentation project. However, in the staff's view, the Board's decision to distinguish the remeasurement component from other items of profit or loss requires that the Board specify what is included in the remeasurement component. We also note that specifying the remeasurement component would be consistent with the views of constituents who ask that the Board improve comparability of reporting pensions across entities by specifying the presentation of pension costs, rather than leaving it up to preparers to choose.

13. Accordingly we recommend that the Board specifies what is included in the remeasurement component.

14. Two questions arise:

    a. should the remeasurement component include the effects of all the changes in actuarial assumptions, in particular changes in service cost assumptions?

    b. should any part of the change in plan assets be included in the financing component, rather than in the remeasurement component?

Changes in service cost caused by changes in assumptions

15. In describing Approach 2 of the DP, the Board stated that entities should account for changes in service costs caused by changes in assumptions other than the discount rate in the same way as service costs. The Board argued that the gains or losses associated with service costs are a re-estimate of service costs and to do otherwise might encourage misestimation of service costs to achieve an accounting result.

16. Some constituents have criticised[1] this view on the grounds that the division of actuarial gains and losses into different types is arbitrary. They argue that it is not meaningful to disaggregate gains and losses into those relating to changes in the discount rate and other changes[2], in particular because of the interaction between the discount rate and inflation assumptions. They also state that there is no conceptual basis for such an allocation[3].

17. Some comment letters argued that only the service cost is relevant in projecting the ongoing operational costs of the business entity.[4] They state that it is not useful to combine information with different predictive value by combining changes in estimate of service cost with the service cost.

18. We agree with respondents that it is arbitrary and complex to divide the gains and losses on the defined benefit obligation into those arising from changes in the discount rate and those arising from other factors. We also argue that changes in plan liabilities arising from other factors are just as much remeasurements as changes arising from changes in the discount rate.

19. We recommend that changes in service cost caused by changes in all assumptions should be in the remeasurement component.

How should the change in plan assets be classified

20. We note the following possibilities:

    a. the total change in plan assets is part of the remeasurement component

    b. the total change in plan assets is part of the financing component

    c. the change in plan assets has a remeasurement and a financing component.

Classifying the total change in plan assets in one component.

21. In the staff's view, including all the total change in plan assets in one component is inconsistent with the Board's tentative decision to disaggregate the net pension cost into employment, financing and remeasurement components. If plan liabilities have separate financing and remeasurement aspects, then so also do plan assets.

[1] Criticism was also implied by constituents who supported approach 2 in principle but proposed a variation in which only the service cost, and not changes in service costs caused by changes in assumptions other than the discount rate is recognised in profit or loss.
[2] CL81 AAA
[3] eg CL21 FARS SRS
[4] CL81 AAA

22. Consistency of treatment with plan liabilities is most clearly illustrated in the case of interest-bearing assets such as bonds. For such assets, separating interest income based on current yields from other changes in value results in a very similar disaggregation to that applied to the pension liabilities. Not applying the same disaggregation to those assets as applies to the plan liabilities would be inconsistent.

23. We think that, in principle, the change in value of any asset can be divided into a change that arises from the passage of time and other changes. The responses to the discussion paper also indicated widespread support for the disaggregation of the total change in plan assets into an amount that arises from the effect of the time value of money and an amount that results from the effects of changes in the underlying assumptions. (This view is discussed further in paragraphs 26ff).

24. We also note that if the total change in plan assets is included in the financing component, many constituents will argue that there is little point in distinguishing the remeasurement component separately on the face of the income statement. In many cases, the biggest volatilities relating to remeasurements arise from changes in plan assets.

25. Accordingly, we recommend that the Board does not include the total change in plan assets wholly in the financing component or the remeasurement component.

Total change in plan assets has a remeasurement and a financing component

26. The discussion paper noted that many regard the relationship between interest cost on the post-employment benefit obligation and interest income on plan assets as an important economic effect of a funded plan. The interest cost that arises from discounting the post-employment benefit obligation represents changes in the amount of liability because of the passage of time. Thus, some think that entities should link that interest cost with interest income on plan assets that also arises because of the passage of time.

27. As stated in paragraph 10.b, the interest cost that arises from discounting the post-employment benefit obligation is classified in the financing component. Thus, the part of the change in plan assets that represents interest income should also be classified in the financing component. In other words, the change in plan assets would be divided into:

a. a financing component, namely an interest income that arises from the passage of time; and

b. a remeasurement component, namely all other changes in the value of plan assets.

Identifying a financing component in the change in plan assets

28. The responses to the discussion paper indicates wide support for the view that there should be a link between interest cost on the post-employment benefit obligation and interest income on plan assets. However, the Board found it difficult to distinguish interest income on plan assets from other changes in the value of plan assets. The DP discussed the following approaches:

    a. using dividends received on equity plan assets and interest earned on debt plan assets (using the current rate market participants would require for equivalent assets).

    b. using market yields at the reporting date on high quality corporate bonds to input interest income.

    c. using the expected return on plan assets, as currently required by IAS 19.

Dividends received on equity plan assets and interest earned on debt plan assets

29. This approach was included because it is an objective and non-arbitrary way to approximate interest income on plan assets.

30. However, the discussion paper set out the Board's concern that entities would recognise returns from dividend-paying equity investments separately from returns from non-dividend-paying equity investments if only dividends received on equity plan assets (rather than all returns) were classified in interest income. This could create an incentive for some entities to invest in particular plan assets to achieve an accounting result, rather than for economic reasons.

31. This approach received almost no support in the comment letters. The reasons given were:

    a. this approach would encourage management to favour plan assets that produce income over those that produce capital growth. This would result in financial statements that are not neutral. For example:

"We are concerned that the inclusion of actual interest and dividend income on plan assets in the income statement, while factual, would create a bias towards the selection of certain types of investment."[5]

b. this approach would misrepresent the performance of plan assets that were invested in non-dividend-paying equities, or in property.

c. distinguishing realised returns from other changes in the fair value of plan assets had no meaningful economic basis.

32. In the light of the Board's reservations in the discussion paper and the views expressed in the comment letters, the staff recommends that the Board reject using dividends received on equity plan assets and interest earned on debt plan assets as a means to identify the financing component in the return on plan assets.

Imputed rate of interest

33. Many of the comment letters supported imputing interest income using the same discount rate as used to determine the defined benefit obligation. This would mean that interest income would be calculated using market yields at the reporting date on high quality corporate bonds.

34. This approach is consistent with the views of those who argue that the financing cost should represent the net interest on the pension surplus or deficit. They argue that the financing component should be derived from looking at the surplus or deficit in the plan, not the underlying assets and liabilities. It is the net amount that is recognised in the statement of financial position. From this perspective, a deficit represents contributions to be paid in the future. The appropriate rate to apply to those contributions under IAS 19 is the high quality corporate bond rate. That is exactly what would happen for an unfunded plan. Similarly, a surplus represents benefits to be received in the future in the form of refunds or reductions in contributions. Again, IAS 19 specifies the use of a high quality corporate bond rate to determine the present value of these benefits.[6]

35. Respondents also supported this approach because of its simplicity. Eg:

[5] CL114 HSBC

[6] Paragraph 58 of IAS 19 states: "The present value of these economic benefits shall be determined using the discount rate specified in paragraph 78 [ie determined by reference to market yields at the end of the period on high quality corporate bonds."

"In our view [this approach] is a simple, pragmatic and in no way inconsistent approach of treating interest costs on pension obligations and interest income on plan assets in a symmetric manner."[7]

"…the calculation is easy to understand, and analysts can easily substitute their own assessment of expected return if they wish. On this basis, information should also continue to be provided about the nature and split of scheme assets held, to permit analysis to undertake their own assessment of investment returns." [8]

36. This view also has the advantage that there would be nil net interest for a plan funded at a breakeven level (ie with no surplus or deficit). Some argue that if there is no asset or liability in the statement of financial position, there can be no interest income or expense because there is nothing to generate it. In contrast, if the expected return is used to determine the financing component, a plan with breakeven funding would probably generate net interest income, as could a plan with a small deficit.

37. However, the following concerns were expressed about this approach:

   a. there is no benefit in replacing expected return on plan assets with another arbitrary measure described as interest income on plan assets. Some of those holding this view argue that the concept of expected return on plan assets is understood and relatively transparent (due to disclosure of expected rates of return) and would seem the most appropriate way to estimate 'interest income'.

   b. the selection of the imputed rate of interest is arbitrary. It would reflect the economic situation only if the plan assets were invested in AA corporate bonds. Otherwise, there would be no economic meaning to the interest income figure.

   c. using an imputed rate of interest does not reflect differences between plans that have different asset allocations. Eg:

   "Such an alternative does not take into account where plan assets are actually invested and would likely result in measurements that vary widely versus actual asset returns over time."[9]

[7] CL46 EON
[8] CL119 Abelica Global
[9] CL40 EXXON Mobil

d. there would be a period of education and confusion amongst users until they adjust to a new definition of "interest income on scheme assets".

38. It is also possible that some of those supporting using market yields at the reporting date on high quality corporate bonds to input interest income did so only in the context of the Board's preliminary view that entities should not divide the return on assets into an expected return and an actuarial gain or loss.

Expected return on assets

39. In the DP, the Board set out its preliminary view that entities should not divide the return on assets into an expected return and an actuarial gain or loss. This preliminary view was very strongly held by many Board members. However, many respondents to the comment letters disagreed with that preliminary view.

40. They state that the expected rate of return[10] contains meaningful information about long-term net pension cost. They are critical of the discussion paper's argument that the subjectivity inherent in determining the expected rate of return provides entities with an opportunity to manipulate profit or loss. They argue:

a. Concerns about subjectivity and anti-abuse are not consistent with writing principles-based standards. Abuse is a problem for regulators and auditors and should not be the basis for standard-setting.

b. Concerns about the appropriateness of the rates chosen should be dealt with by better policing, stronger guidance and enhanced disclosure, eg of sensitivities and historical record. Sufficient reliable information is available to support estimates of expected return rates. Comment letters also suggested that information should continue to be provided about the nature and split of scheme assets held, to permit analysts to undertake their own assessment of investment returns.

c. The Board is willing to accept much greater subjectivity in other areas, including the estimation of fair value assuming the benefit does not change for contribution-based promises.

d. The Board cannot eliminate the potential for abuse by eliminating the expected return on assets. There is equal subjectivity, and possibly greater

[10]For this meeting, we have not considered how we would defined expected return. We could consider, for example, whether further guidance should be given on (1) whether the expected return is the long-term return or return over the next period and (2) is the return applied to the fair value of plan assets or to some base reflecting the long-term expected return.

effect, in other assumptions inherent in determining the defined benefit obligation.

e. In practice, the management of pension funds, including funding decisions, is often based on the long-term expected return on assets. The use of expected return provides information about management policy and thinking.

41. Using an expected return on assets to calculate interest income received widespread support from working group members and users. Those constituents acknowledged that there had been abuse in the past but noted that such abuse could be addressed through other ways, eg improved disclosure such as of sensitivities to changes in expected return and how the expected return was calculated and of historical comparisons of expected against actual return. Eg:

"We acknowledge that the measure is somewhat subjective for asset classes such as equities, but such uncertainty is inherent in estimates included in other items in a company's accounts. There are reasonably well-established approaches to calculating an expected return on assets, and financial commentators who draw attention to the use of assumptions that are outside the norm. Indeed, it is very easy for an accounts user who wishes to adjust the expected return to reflect different return assumptions."[11]

Choosing between imputed rate of interest and expected return

42. If the Board agrees to the staff recommendations in paragraphs 23 and 32, it must choose between an imputed rate of interest and an expected return on assets for calculating interest income on plan assets.

43. **The staff recommends that the Board require that interest income is calculated using the expected rate of return**, for the following reasons:

a. 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, conveys decision-useful information to users of financial statements.

b. using the same rate used to discount the defined benefit obligation:

[11] CL119 Abelica Global

   i. does not reflect the economic differences that arise when plan assets are invested in different ways
   ii. does not reflect economic differences that arise from the allocation of plan assets.

c. the Board's arguments for eliminating expected return are difficult to support. In particular:
   i. there is equal subjectivity inherent in other areas of IFRSs
   ii. eliminating abuse is better dealt with by better auditing.
   iii. concerns about the appropriateness of the rates chosen could be addressed by improved disclosure and stronger guidance.