Project **Post-employment benefits**

Topic **Defining the finance cost component**

Objective

1. This paper provides:

   (a) Background, including an overview of the proposed definition of the finance cost component in the exposure draft *Defined Benefit Plans* (the ED) (paragraphs 3 - 5).

   (b) An overview of comments received on the ED relating to determining interest income on plan assets (paragraphs 6-16).

   (c) A staff analysis of those responses (paragraphs 17 – 32).

Staff recommendation

2. The staff recommends that the Board define the finance cost component based on the expected return (paragraphs 33 – 34). If the Board agrees with the staff recommendation but has concerns about the subjectivity of the expected return approach, then the staff suggests that the Board should amend the requirements to include a requirement to determine expected return on plan assets in a manner consistent with the measurement of those plan assets at fair value.

Background

3. The exposure draft proposed that the finance cost component of changes in the defined benefit obligation and plan assets should comprise net interest on the net

defined benefit liability or asset. The Basis for Conclusions on the ED characterised net interest on the net defined benefit liability or asset as the change in the net defined benefit liability or asset arising from the time value of money. The ED proposed that this change be determined by applying the rate used to discount the defined benefit obligation to the net defined benefit liability or asset.

4. The Basis for Conclusions on the ED noted that determining the finance cost component in this way implicitly sets the interest income arising on plan assets at the amount determined by applying the rate used to discount the defined benefit obligation to the plan assets. The staff has reproduced the relevant sections of the Basis for Conclusions in Appendix A. The responses to question 5 of the ED focussed on this aspect of the proposals, therefore this paper also focuses on this issue. The staff does not plan to consider all the possible approaches to determining interest income on plan assets because the Board has already had detailed technical discussions covering other possible approaches in developing the ED and the comment letters suggested no additional alternatives. Instead, this paper focuses on the following two approaches:

   (a) The **net interest approach –** the approach proposed in the ED.

   (b) The **expected return approach –** the approach in IAS 19. The Board rejected this approach in developing the ED because the expected return on assets could not be determined in an objective way and because it might include a return that is not simply due to the passage of time.

5. This paper does not replicate the analyses already discussed by the Board in developing the ED. Board members should refer to Appendix A which reproduces the Basis for Conclusions on the ED and contact the staff for additional relevant background materials if needed.

Overview of comments received on the ED

6. Question 5 of the ED asked respondents the following:

> The exposure draft proposes that the finance cost component should comprise net interest on the net defined benefit liability (asset) determined by applying the discount rate specified in paragraph 78 to the net defined benefit liability (asset). As a consequence, it eliminates from IAS 19 the requirement to present an expected return on plan assets in profit or loss.
>
> Should net interest on the net defined benefit liability (asset) be determined by applying the discount rate specified in paragraph 78 to the net defined benefit liability (asset)? Why or why not? If not, how would you define the finance cost component and why? (Paragraphs 7, 119B, 119C and BC23–BC32)

7. This overview presents the views expressed:

   (a) in the comment letters in response to Question 5 (paragraphs 8 – 12),

   (b) by the Board's Employee Benefits Working Group (EBWG) (paragraphs 13 – 16)

8. The views in the comment letters were mostly consistent with the views heard in other outreach activities undertaken by the staff during the comment period. However the staff has included in this paper the views heard during outreach, particularly from users, that were not presented in comment letters.

Views in the comment letters

9. Some responses supported the net interest approach and some supported the expected return approach. A majority of preparers and pension funds (both companies and associations) supported the expected return approach, a majority of actuaries (both firms and professional bodies), accounting professional bodies and national standard setters supported the net interest approach, while views from the accounting firms and users were mixed with no clear majority supporting either approach. Very few respondents advocated that the whole of the actual return on assets should be part of the finance cost.

10. Respondents that supported the expected return approach stated their reasons as follows:

    (a) *Relevance and comparability* - The expected return approach reflects the underlying economics of the plan assets and therefore it provides more relevant information about the plan assets than the net interest approach which does not reflect the underlying economics of the plan assets. Accordingly, the expected return approach provides a more meaningful comparison between entities. In addition, the discount rate requirements in paragraph 78 result in economically-similar liabilities being measured at different amounts depending on whether a deep market in high quality corporate bonds exists. Applying this rate to the assets as well would exacerbate this anomaly.

    (b) *Consistency with measurement* - The expected return approach could be seen as more consistent with measuring plan assets at fair value because the expected return approach is the rate implicitly or explicitly used to discount the future cash flows of the assets to get to the fair value. The net defined benefit asset or liability results from netting the defined benefit obligation measured using the projected unit credit method against the plan assets measured using fair value. Applying the discount rate used to measure the liability to the net amount on the balance sheet is inconsistent with how the net amount is measured.

    (c) *Convergence* - The expected return approach is consistent with US GAAP requirements. The net interest approach will introduce divergence between IFRS and US GAAP requirements.

    (d) *Subjectivity* - Determining the expected return approach may be subjective. However, other areas of accounting require management judgment and are equally subjective. Although subjectivity may provide an opportunity for abuse, that should not be the primary concern of the Board. Accordingly, some respondents propose that the Board address concerns about the use of management’s judgment through improved disclosure, or by using other ways to limit the range of management judgment in determining expected returns.

(e) *Effect on behaviour* - The net interest approach would discourage investment in equities because the finance cost will not reflect the higher returns expected over the long-term. As a result, supporters of the expected return approach believe that the net interest approach may lead to sub-optimal investment decisions. They also believe that those decisions would cause widespread sales of equity investments that would depress equity prices unjustifiably.

11. Some respondents expressed a qualified support for the expected return approach. Even though these respondents do not agree with defining the finance cost component based on the expected return approach, they do not believe that the net interest approach is a significant enough improvement in financial reporting to justify a change in the existing requirements of IAS 19. These respondents argue that the Board can still achieve its objectives of improving comparability and understandability by eliminating the existing presentation options in IAS 19, and that these benefits can be achieved without eliminating the expected return approach.

12. Respondents that supported the net interest approach stated their reasons as follows:

(a) *Understandibility* - The net interest approach is a simple and pragmatic solution to a complex problem. The net interest approach is more understandable because an asset (ie surplus) will give rise to interest income, and a liability (ie deficit) will give rise to interest expense. This is not necessarily the case for the expected return approach because a net liability may give rise to interest income if the expected return on the assets is sufficiently greater than the discount rate on the defined benefit obligation.

(b) *Comparability* - The net interest approach improves comparability because it requires entities to calculate the finance cost using the same rate.

(c) *Reporting expected performance* - The expected return approach is based on expectations at the beginning of the year and does not reflect the actual performance of the assets during the year. The net interest approach is also based on expectations at the beginning of the year. However the net interest approach reflects the effect of the passage of time on the net defined benefit asset or liability independently of what the underlying plan assets are.

(d) *Subjectivity* - The discount rate for the defined benefit obligation is more objective than the expected return approach.

(e) *Effect on behaviour* - The net interest approach presents both the benefits of taking risk (ie the higher returns expected from risk assets) and costs of taking risk (ie the higher losses that might arise from riskier investments) in the remeasurement component. In contrast, the expected return approach presents the benefits of taking risk in the finance component but the costs in the remeasurements component. Some argue that this treatment creates an uneconomic incentive to invest in risk assets. Therefore a disaggregation based on the net interest approach is more neutral than the expected return approach.

Views from the EBWG

13. The EBWG met on 27 September 2010. Amongst other topics, the EBWG discussed the net interest approach proposals, and responses to those proposals. Like the comment letters, the views of the EBWG members were divided between the net interest approach and the expected return approach. However the comments of the EBWG members provided some insight into the assessment of the arguments for and against both approaches.

14. Members of the EBWG placed greater weight on the following arguments in support of the net interest approach:

    (a) *Understandability* - the view that the net defined benefit asset or liability on the balance sheet represents a receivable or payable to the plan and the net interest approach represents the income and expense resulting from the financing decision of the entity.

    (b) *Reporting expected performance* - members were concerned that the expected return approach presents the return expected at the beginning of the period as the performance during the period regardless of the actual performance of the assets during the period.

15. Members of the EBWG placed greater weight on the following arguments in support of the expected return approach:

    (a) *Relevance and comparability* - the concern that the net interest approach does not represent the underlying economics of the plan assets. The expected return approach provides more predictive value.

    (b) *Consistency with measurement* - the view that the net defined benefit asset or liability on the balance sheet results from netting the defined benefit obligation which is measured using the projected unit credit method, with the plan assets which are measured at fair value.

16. Members of the EBWG placed less weight on the following arguments:

    (a) *Subjectivity* - while the degree of subjectivity is a concern in the expected return approach, it is a concern that is present in most accounting judgments.

    (b) *Effect on behaviour* - Concerns about how the proposals would affect behaviour could be argued to support either approach. Some argue that the net interest approach provides an uneconomic incentive not to invest in risk assets. Others argued that the expected return approach provides an uneconomic inventive to invest in risk assets.

Staff analysis and recommendation

17. This section assesses the arguments for and against both approaches regarding the following:

    (a) Relevance, comparability and understandability (paragraphs 18 – 24)

    (b) Consistency with measurement (paragraphs 25 – 26)

    (c) Reporting expected performance (paragraph 27)

    (d) Convergence (paragraphs 28 – 29)

    (e) Subjectivity (paragraphs 30 – 31)

    (f) Effect on behaviour (paragraphs 32)

Relevance, comparability and understandability

18. Supporters of both the net interest approach and the expected return approach argue that their approach produces more relevant, comparable and understandable information.

19. The staff believes these contrasting views reflect how different respondents consider the net defined benefit asset or liability recognised in the balance sheet as either:

    (a) Comprising two components (the plan assets and the defined benefit obligation) which are measured separately but presented together (the gross view), or

    (b) Representing a single amount owed to, or from, the plan (the net view).

20. These differences in views may reflect differences plan design in different geographical regions such as the degree of control an entity may have of the plan assets.

21. The expected return approach is more consistent with the gross view and the net interest approach is more consistent with the net view. The Board supported the net view in the basis for conclusions on the ED since this is consistent with the

presentation of the net defined benefit asset or liability in the statement of financial position.

22. The staff agrees with the view that the expected return approach provides more comparable information about the plan assets than the net interest approach because the expected return approach is determined based on the underlying plan assets, while the net interest approach is determined independent of the underlying plan assets. However, the discount rate is also determined independently of the underlying defined benefit obligation. Some believe that the board should apply the same approach to both the plan assets and the defined benefit obligation.

23. The requirements of paragraph 78 can result in economically similar defined benefit obligations being reported at different amounts on the balance sheet depending on whether there is a deep market in high quality corporate bonds. The Board has attempted to address this issue in a separate ED, but decided to defer consideration of the discount rate until the Board decides to review measurement of the defined benefit obligation as a whole.

24. The staff agrees with the view that the net interest approach provides more understandable information about the net defined benefit asset or liability because it will eliminate the anomaly where a liability (deficit) could result in interest income.

Consistency with measurement

25. 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 are measured on different measurement bases. The plan assets are measured at fair value and the defined benefit obligation are measured 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 were the net asset or liability to be measured directly.

26. The staff believes that the expected return approach is more consistent with the measurement of the plan assets. The expected return represents the unwinding of discount rate used to measure the plan assets at fair value, in the same way as the interest cost represents the unwinding of the discount rate used to measure the defined benefit obligation.

Reporting expected performance

27. Amounts calculated for service cost, finance cost on the defined benefit obligation and finance income on the plan assets are calculated using the financial and demographic assumptions at the beginning of the year. However there are concerns that, because the expected return approach depends on the economics characteristics of the plan assets, an entity could determine the expected return presented in the finance cost component for the period by allocating the plan assets a particular way at the beginning of the period. In contrast, the discount rate used to calculate the defined benefit obligation is independent of the economic characteristics of the defined benefit obligation. This difference introduces an accounting arbitrage that would be eliminated using the net interest approach because the discount rate would be independent of the underlying plan assets.

Convergence

28. US GAAP defines net periodic pension cost[1] as comprising current service cost, interest cost on the defined benefit obligation, expected return on plan assets, amortization of unrecognized prior service cost (if any), gains or losses recognized and amortized after exceeding a certain corridor (if any), amortization of unrecognized initial net obligation and/or initial net asset.

29. The disaggregation proposals in Agenda Paper 4C will diverge from the requirements of US GAAP regardless of whether the Board confirms the net interest approach or not. However the expected return on plan assets is a part of

[1] FASB Accounting Standards Codification Section 715-30-20 Defined Benefit Plans-Pension Glossary

the net periodic pension cost and confirming the net interest approach will cause greater divergence from US GAAP.

Subjectivity

30. The staff agrees with the views that there is no more subjectivity in determining the expected return approach than in many other aspects accounting judgments. The degree of subjectivity involved in determining an accounting estimate depends on the degree of availability of observable inputs, instead of the accounting approach adopted. For example, an entity's plan assets may be invested in an active equity market while the bond market in the currency of the defined benefit obligation is inactive. In this case determining the rate used to discount the defined benefit obligation would be more subjective than determining the expected return on plan assets. Therefore, the net interest approach is not necessarily a more objective approach than the expected return approach.

31. If the Board has concerns about the subjectivity of the expected return approach but wishes to proceed with the expected return approach, then the staff suggests that the Board should amend the requirements to include a requirement to determine expected return on plan assets on a basis consistent with the measurement of those plan assets at fair value.

Effect on behaviour

32. As noted previously, the supporters of both the net interest approach and the expected return approach have argued that their approach does not provide an uneconomic incentive to invest assets in a particular way. The staff believes that the Board should decide on the approach that provides the most relevant information that faithfully represents the changes in the plan assets and defined benefit obligation. The staff agrees with the EBWG members that suggested that the Board should not base its decision on a wish to avoid encouraging or discouraging any particular behaviour.

Staff recommendation

33. In summary the staff believes that:

(a) the expected return approach is consistent with the measurement of the net defined benefit asset or liability and reflects the underlying economics of the plan assets. It therefore provides more comparable information. While the expected return approach is not necessarily more subjective than the net interest approach, it results in reporting of the expected performance of the plan assets.

(b) the net interest approach is consistent with the presentation of the net defined benefit asset or liability, is a simple and pragmatic solution and therefore provides more understandable information. However the net interest approach diverges from US GAAP and does not reflect the underlying economics of the plan assets.

34. The staff believes that the advantages and disadvantages do not clearly favour either the expected return approach or the net interest approach. Therefore the staff does not believe that the net interest approach represents a significant enough improvement to justify a change in the existing requirements of IAS 19. The Board can still achieve its objectives of improving comparability and understandability by eliminating the existing presentation options, and these benefits can be achieved with expected return approach.

Question 1
Does the Board agree that it should define the finance cost component based on the expected return approach? If yes, does the Board agree to include a requirement to determine expected return on plan assets consistent with the measurement of those plan assets at fair value?

Appendix A – Basis for Conclusions

This appendix reproduces the section on the finance cost component from the Basis for Conclusions on the ED Defined Benefit Plans.

The finance cost component

BC 23 The discussion paper acknowledged the widespread view that an important economic effect of a funded plan is that part of the change in plan assets arises from the passage of time, and this part offsets the interest cost that arises from the defined benefit obligation.

BC24 The Board concluded that, in principle, the change in value of any asset can be divided into an amount that arises from the passage of time and other changes. Similarly, the interest cost on the defined benefit obligation arises from the passage of time. Therefore, the Board proposes that the finance cost component should include not only the interest cost on the defined benefit obligation but also the part of the return on plan assets representing changes arising from the passage of time.

BC25 Furthermore, the amount arising from the passage of time does not have the same implications for predicting the amounts, timing and uncertainty of future cash flows as the amount that represents all other changes in the fair value of the plan assets. Therefore, to be consistent with the Board's proposal that components of defined benefit cost with different predictive implications should be presented separately (see paragraphs BC14–BC18), the Board proposes that the finance cost component should not include the part of the return on plan assets that does not arise from the passage of time.

BC26 The Board found it difficult to find a practical method for identifying the change in the fair value of plan assets that arises from the passage of time, particularly for assets that do not bear explicit interest. The Board rejected approximations to this amount using:

(a) the expected return on plan assets (as currently required by IAS 19) because it could not be determined in an objective way (see paragraph BC41) and because it might include a return that is not simply due to the passage of time; and

(b) dividends (but not capital gains) received on equity plan assets and interest earned on debt plan assets (using the current rate that market participants would require for an equivalent asset). In the Board's view, dividends are not a faithful representation of the time value of money.

BC27 To calculate interest income on plan assets, the exposure draft proposes that entities should apply the rate used to discount the defined benefit obligation.

BC28 This approach produces interest income that is equivalent to determining a net finance cost on the net defined benefit liability (asset). In the Board's view, a net finance cost provides more understandable information than finance income and expenses determined separately on the underlying assets and liabilities that combine to make a net defined benefit liability (asset).

BC29 A net defined benefit liability is equivalent to a financing amount owed by the reporting entity to the plan or to the employees. The economic cost of that financing is interest cost, calculated using the rate specified in paragraph 78. Similarly, a net defined benefit asset is an amount owed by the plan to the reporting entity. The reporting entity accounts for the present value of economic benefits that it expects to receive from the plan in the form of reductions in future contributions or as refunds. The reporting entity discounts those economic benefits using the rate specified in paragraph 78.

BC30 Thus a reporting entity recognises interest income when the plan has a surplus, and interest cost when the plan has a deficit.

BC31 Some state that the existing model in IAS 19 cannot accommodate a net interest approach of the type described in paragraphs BC28–BC30. Although the basis of presentation in the statement of financial position under IAS 19 is that the entity has a net deficit or surplus, those holding this view believe that the surplus or deficit arises from the combination of two items that generally have different economic drivers, have different explicit or implicit discount rates and are measured on different bases.

BC32 The Board acknowledges the limitation of a net interest approach, ie that plan assets may be made up of many different types of investments, and that the return on high quality corporate bonds would be arbitrary and would not be a faithful representation of the return that investors require or expect from each type of asset. However, using the same rate as the rate used to discount the liability is a practical expedient that:

(a) would not require an entity to make a subjective judgement on how to divide the return on plan assets into an interest component and a remeasurement.

(b) results in amounts recognised in profit or loss that reflect the effect of the time value of money on both the defined benefit obligation and on plan assets. Therefore, the amounts recognized in profit or loss reflect the differences between funded and unfunded plans.

The presentation options in IAS 19 consistent with immediate recognition

BC40 Many respondents to the discussion paper suggested that the Board should deal only with recognition in this project, retaining both presentation options currently in IAS 19 that are consistent with immediate recognition. This approach would permit entities to recognise actuarial gains and losses, as defined in IAS 19, either in profit or loss or in other comprehensive income.

BC41 However, the presentation options in IAS 19 would require entities to recognise in profit or loss an expected return on assets. The difference between the actual and expected return on assets forms part of the actuarial gains and losses that entities currently recognise in profit or loss or in other comprehensive income. The Board believes that an entity’s expectations about the return on plan assets are less relevant than the actual return on plan assets. In addition the Board sees a possible danger that the subjectivity inherent in determining the expected rate of return could provide entities with an opportunity to manage profit or loss. Accordingly, the Board concluded that entities should not divide the return on assets into an expected return and an actuarial gain or loss (see paragraph BC26(a)). Some of the presentation options in IAS 19 would not be consistent with this conclusion. Furthermore, perpetuating options in IAS 19 would not improve financial reporting.