Project **Post-employment benefits**

Topic **Presentation: response to proposals in the ED**

Objective

1. This paper provides an overview of the presentation proposals in the exposure draft ('ED') and the responses received in the comment letters. This paper discusses the following issues:
    (a) The ED proposals (paragraphs 2 - 13)
    (b) Issues in the responses to the proposals
        (i) Defining the finance cost component (paragraphs 15 - 19)
        (ii) Presentation of the components of defined benefit cost (paragraphs 20 - 29)

The ED proposals

2. The ED proposed that entities disaggregate changes in the defined benefit obligation and the fair value of plan assets into service cost, finance cost and remeasurement components and present:
    (a) the service cost component in profit or loss (paragraph 6);
    (b) the finance cost component, ie net interest on the net defined benefit liability or asset, as part of finance costs in profit or loss (paragraphs 7 - 11); and
    (c) the remeasurement component in other comprehensive income (paragraphs 12 - 13).

This paper has been prepared by the technical staff of the IASB for the purposes of discussion at a public meeting of the IASB working group identified in the header of this paper.

The views expressed in this paper are those of the staff preparing the paper and do not purport to represent the views of any individual members of the Board or the IASB.

The meeting at which this paper is discussed is a public meeting but it is not a decision-making meeting of the Board.

Official pronouncements of the IASB are published only after the Board has completed its full due process, including appropriate public consultation and formal voting procedures.

3. Consequently, the ED proposes to remove from IAS 19 the option for entities to recognise in profit or loss all changes in defined benefit obligations and in the fair value of plan assets.

4. The ED also proposed that:

   (a) gains and losses on routine and non-routine settlements are actuarial gains and losses and should be included in the remeasurement component that is presented in other comprehensive income, and

   (b) curtailments should be treated in the same way as plan amendments, with gains and losses on curtailment presented in profit and loss.

5. This paper does not discuss the feedback received on the presentation proposals for settlements and curtailments.

The service cost component

6. Service cost comprises current service cost and past service cost. The ED proposed that service cost should exclude gains and losses arising from changes in the estimates of assumptions used to measure the service cost because, in the Board's view, the predictive value of service cost differs from the predictive value of changes in the estimate of service cost. Consequently, the service cost component would be more relevant to users of financial statements in assessing an entity's ongoing operational costs if it did not also contain current period changes in past estimates of service cost.

The finance cost component

7. The ED (and the discussion paper that preceded it) 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. Accordingly, the ED proposes to divide the return on plan assets into an amount that arises from

the effect of the time value of money and another amount that results from all other changes in fair value.

8. 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. In developing the ED, the Board considered and rejected approximations to this amount using:

   (a) The expected return on plan assets because it 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; and

   (b) Dividends and interest received because dividends are not a faithful representation of the time value of money.

9. The ED proposes that entities approximate the change in the fair value of plan assets that arises from the passage of time using interest income, calculated by applying the rate used to discount the defined benefit obligation to the plan assets.

10. This approach produces interest income that is equivalent to determining a net finance cost on the net defined benefit liability (asset). Although the Board previously rejected this approach in the discussion paper, it concluded that presenting a net finance cost would provide more understandable information than interest expense or interest income determined separately on the underlying assets and liabilities that combine to make a net defined benefit liability (asset).

11. The ED acknowledged 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, the ED proposes that entities use the same rate for plan assets as they use to discount the liability as it:

(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 remeasurement component

12. The ED defines the remeasurement component as comprising:

    (a) actuarial gains and losses on the defined benefit obligation;

    (b) the return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset);

    (c) any changes in the effect of the limit described in paragraph 115B (ie the asset ceiling), excluding the amount included in net interest on the net defined benefit liability (asset).

13. The ED proposes that entities should present the remeasurement component as an item of other comprehensive income. The Board concluded that the changes included in the remeasurement component have different information value compared to other components of defined benefit cost because they provide less useful information about the likely timing and amount of future cash flows than those other components, although they do provide information about the uncertainty of the cash flows. In the Board's view, presentation of the remeasurement component in other comprehensive income is the clearest way to distinguish it from other components of defined benefit cost.

Issues in the response to the proposals

14. Many support the improved comparability that would arise from removing options for presenting changes in defined benefit assets or liabilities. However,

there are mixed views on the specific disaggregation and presentation proposals in the ED.

Defining the finance cost component

15. Most comments on the disaggregation proposals focused on the definition of the finance cost component. Views were split between those that support the net interest approach in the ED and those that support maintaining the expected return on assets (EROA). Very few respondents advocated that the actual return on assets should be part of the finance cost.

16. Many preparers and some users of financial statements would like the Board to retain the EROA. These respondents supported the EROA over the net interest approach proposed in the ED for the following reasons:

    (a) The EROA represents the underlying economics of the plan assets and therefore is more relevant and provides better comparability between entities. The net interest approach does not represent the underlying economics of the plan assets and therefore reduces comparability between entities.

    (b) the net interest approach proposed in the ED would be a disincentive for plans to invest in equities and would therefore have adverse implications for the equity markets.

    (c) The EROA is more consistent with measuring plan assets at fair value because it could be seen as the implicit rate 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 DBO 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.

(d) The EROA is consistent with US GAAP requirements. The net interest approach will introduce divergence between IFRS and US GAAP requirements.

(e) The discount rate requirements in paragraph 78 result in economically similar liabilities being measured at different amounts depending on whether there is a deep market in high quality corporate bonds. Applying this rate to the assets as well would exacerbate this anomaly.

17. Supporters of EROA acknowledge that determining the EROA in profit or loss may be subjective. However, they argue that other areas of accounting require management judgment and are equally subjective. Although subjectivity may provide an opportunity for abuse, that should be the concern of auditors and regulators. Accordingly, they propose that the Board address concerns about the use of management's judgment through improved disclosure.

18. Some respondents do not believe that the net interest approach is a significant enough improvement in financial reporting to justify a change, even though they do not agree with the current requirement in IAS 19 to present the expected return on assets in profit or loss. These respondents argue that the Board can still achieve its objectives of improving comparability and understandability by eliminating the existing presentation options, and these benefits can be achieved without eliminating the EROA.

19. Respondents that supported the net interest approach in the ED over the EROA for the following reasons:

(a) The net interest approach may not be the ideal solution, but it is a simple and pragmatic solution to a complex problem.

(b) The net interest approach will improve understandability because an asset (ie surplus) will give rise to interest income, and a liability (ie deficit) will give rise to interest expense.

(c) Using the discount rate for the DBO is more objective than the EROA and will improve reliability;

(d) Existing IAS 19 presents the expected return on assets in profit or loss and does not require that any losses on those assets are presented in the same place. Thus, the higher returns expected from taking higher risk in assets are presented in profit and loss, without any offset from the cost of the risk (ie losses). Some argue that this treatment creates an uneconomic incentive to invest in risk assets. In contrast, the net interest method results in both the returns on assets and any losses on those assets being presented in OCI. Thus, it can be argued that the net interest method is more neutral.

(e) The EROA is based on expectations at the beginning of the year and does not reflect the actual performance of the assets during the year and therefore is less relevant than the actual return on assets. The net interest approach will reflect the effect of the passage of time on the net defined benefit asset or liability and therefore is more relevant.

Discussion questions
Do you agree with the arguments for or against the EROA and the net interest approach? Is there anything else the Board should consider?

The presentation of the components of defined benefit cost

20. The views expressed on the presentation can be summarized as follows:

(a) Support for the presentation proposals in the ED.

(b) Support for requiring or permitting a single 'employee cost' (ie presenting the service cost and finance cost together).

(c) Support for recycling amounts in OCI through profit and loss.

(d) Support for retaining the option for presenting all components through profit and loss.

21. In many cases, respondents discussed the presentation proposals in the ED in the context of the fundamentals of performance reporting, the links with other related IASB projects including *Financial Statement Presentation* (FSP) and *Presentation of Items of Other Comprehensive Income* and the distinctions that are being made between items in OCI and items in profit and loss in various other IASB projects and current standards.

22. Many respondents supported the ED's proposal to present service cost in profit or loss and finance cost as part of finance costs in profit or loss arguing that this approach would improve comparability the most. However, some respondents believe that entities should be either required or permitted to present the service cost and finance costs in the same line item. Supporters of this approach argue that:

    (a) both the service cost and the unwinding of the liability arise from a benefit provided to the employee (ie a holistic approach).

    (b) the income from the plan assets reduces the cost of the employee benefit (ie the returns from plan assets are cost-reducing rather than income-generating). Those of this view would also support retaining the expected return on assets for the same reason.

    (c) the finance cost arising from defined benefit plans is different in nature to other finance costs (a common view of the banks).

    (d) presenting the service cost and finance cost components together is consistent with the proposal in the FSP project to present finance cost from operating items separately from interest related to financing.

23. Some of these respondents noted that entities manage these costs in different ways and the presentation should reflect the way they manage these costs. Some respondents, especially financial institutions, considered the finance cost component to be different to regular interest and do not support the Board prescribing that the finance cost component be presented together with other finance costs.

24. Many respondents regard the Board's decision to present remeasurements in OCI as a pragmatic approach that can be supported until the Board addresses performance reporting in the Conceptual Framework or another IASB project (such as Financial Statement Presentation). However respondents also express concerns that they perceive no conceptual basis underlying the Board's decisions about when items are presented in OCI and they believe this inevitably creates inconsistencies.

25. There were mixed views regarding whether amounts presented in OCI should be reclassified to profit or loss in subsequent periods ('recycling'). Some supported the proposals in the ED arguing that they were consistent with the current requirements of IAS 19 when using the option to present actuarial gains and losses in OCI. IAS 19 does not currently require recycling of such gains and losses.

26. Some believe that gains and losses should be recycled, for the following reasons:

    (a) The current local GAAP (especially in North America) recycles all items of OCI. Without recycling, net profit under IFRS will diverge from net profit under US GAAP for entities currently applying the corridor method in IAS 19.

    (b) Recycling retains the link between net profit and retained earnings that some regard as important in determining distributable profits.

    (c) The importance of maintaining the 'clean surplus' principle.

    (d) Recycling reduces issues relating to costs to be capitalized as part of the measurement of assets. If recycling is not allowed or permitted, then the Board should clarify how actuarial gains or losses should be included in the cost of such assets.

27. Supporters of recycling usually suggest a mechanism for recycling, such as keeping the existing corridor method in a way similar to US GAAP.

28. Some respondents noted that the presentation model proposed in the ED is inconsistent with the Board's conclusions for financial instruments in IFRS 9. In IFRS 9 an entity can elect to present in OCI gains and losses in the value of an equity instrument that is not held for trading and present dividends from that equity instrument in profit or loss.

29. A few respondents suggested that entities present actuarial gains and losses through profit and loss, either as a requirement, or by retaining the option currently in IAS 19. These respondents argued:

    (a) if an entity holds assets that do not meet the definition of plan assets and accounts for those assets at fair value through profit and loss, it should be able to account for changes in the defined benefit obligation through profit and loss. An example is an entity that holds assets to meet unfunded obligations.

    (b) Since there is no conceptual basis for presenting remeasurements in OCI, presenting all components in profit and loss is the conceptually superior answer and if not required, should at least be permitted.

Discussion questions
Should the finance cost component be presented together with other finance costs within profit and loss? Should presentation of remeasurements in profit and loss be permitted, or required under specified circumstances? If so, when?