

STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	IAS 19 <i>Employee benefits</i>		
Paper topic	Employee benefit plans with a guaranteed return on contributions or notional contributions—Measurement of plans		
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Introduction

1. At the IFRS Interpretations Committee’s meeting in July 2012 we presented four measurement approaches that were developed by staff in 2005 when the Interpretations Committee was redeliberating draft interpretation D9 *Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions*. At the meeting staff did not ask the Interpretations Committee to make any decisions on measurement, but the Interpretations Committee provided the staff with input for consideration.
2. The objective of this paper is to ask the Interpretations Committee to make a decision on the measurement of the employee benefit plans that would fall within the scope of the Interpretations Committee’s current work.
3. The Interpretations Committee tentatively decided at its meeting in September 2012 the scope of the draft interpretation it is working towards. Employee benefit plans should fall within the scope of its work if they have the following characteristics
 - (a) the plans would be classified as defined contribution plans under IAS 19 (or would be defined contribution plans if they were funded by

actual rather than notional contributions) if not for the guarantee provided by the employer on the return of the contributions made;

- (b) the contributions made to the plans can be notional contributions (ie whether the plans are funded or not should not affect the basis of accounting for these plans);
- (c) there should be a guarantee of return by the employer on the contributions (notional contributions) made;
- (d) the benefit under the plans should not be dependent on future events (eg salary changes, vesting or demographic risk); and
- (e) the guarantee under the plan may be based on the value of one or more underlying assets.

4. The Interpretations Committee also tentatively decided that an employee post-employment benefit plan or other employee long-term benefits would fall within the scope of the Draft Interpretation if the employer has a legal or constructive obligation to pay further contributions and the fund does not hold sufficient assets to cover all employee benefits relating to employee service in the current and prior periods in respect of:

- (a) a promised return on contributions, actual or notional; or
- (b) any other guarantee on contributions, actual or notional, based on the value of one or more underlying assets.

Background

5. As discussed above, at the meeting in July 2012 the staff presented the Interpretations Committee with the four measurement approaches that were developed in the redeliberations of D9 in 2005. The four measurement approaches presented were the following:

- (a) fixed/variable approach (this approach was used in D9);
- (b) modified fixed/variable approach;

- (c) pure deconstruction approach; and
- (d) modified deconstruction approach.

6. Agenda paper 11C for the July 2012 Interpretations Committee meeting gave further detail on these approaches. Of the approaches presented, the staff thought that the pure deconstruction approach was the most appropriate, because it gives a result that is a faithful representation of the entity’s obligation, it is broadly applicable to a wide range of plans and it gives consistent results. The pure deconstruction approach was, however, rejected by the Interpretations Committee in April 2005, because it was deemed to be inconsistent with the measurement requirement of IAS 19. This was because IAS 19 does not allow the use of different approaches for different components of the entity’s obligation.
7. In Agenda Paper 4 for the August 2005 meeting of the Interpretations Committee the staff provided the following summary of the measurement approaches that had been developed.

	Fixed/Variable	Modified Fixed/Variable	Pure Deconstruction	Modified Deconstruction
<i>Suitability for complex benefit structures</i>	Not suitable	Not suitable	Suitable	Suitable
<i>Consistency with the standard</i>	Inconsistent with respect to the measurement of the defined benefit obligation and the components of pension expense	Consistent with the standard in respect of the measurement of the defined benefit obligation and the components of the pension expense	Consistent in respect of the measurement of the defined benefit obligation but not the components of the pension expense	Consistent with the standard in respect of the measurement of the defined benefit obligation and the components of the pension expense
<i>Faithful Representation - DBO</i>	Measures the intrinsic value of the embedded guarantee and therefore does not give a faithful representation.	Measures the intrinsic value of the embedded guarantee and therefore does not give a faithful representation.	Measures the fair value of the embedded guarantee and gives a faithful representation.	Measures the fair value of the embedded guarantee and gives a faithful representation.
<i>Faithful Representation – pension cost</i>	The service cost and interest cost are not a faithful representation of the change in the entity’s obligation as a result of additional employee service or the time value of money	The service cost and interest cost are not a faithful representation of the change in the entity’s obligation as a result of additional employee service or the time value of money	The service cost is a faithful representation of the change in the entity’s obligation as a result of additional employee service and the passage of time.	The service cost is a faithful representation of the change in the entity’s obligation as a result of additional employee service. The interest cost for the embedded guarantee is an artificial concept.

8. At the August 2005 meeting the staff recommended that the project on D9 should be referred to the IASB, to be included in the IASB's project on employee benefits, with the aim of developing the pure deconstruction approach as an amendment to IAS 19. The staff also recommended that if the Interpretations Committee decided to continue with the project, the modified deconstruction approach should be used. The Interpretations Committee decided to refer the project to the IASB and did not therefore make any further decisions on measurement, other than rejecting the pure deconstruction approach.
9. A short description of the four approaches is included in the Appendix to this paper.

Staff analysis

10. After considering the four approaches developed in 2005 the staff have decided not to pursue the advocacy of any of these approaches. This is partly because of the problems with the approaches as described in the table above and partly because in our opinion there are basically two measurement issues that the Interpretations Committee needs to address in this project. These issues are the discount rate used in measurement of the defined benefit obligation and the measurement of the 'higher of option'.
11. In addition to that, one of the main messages that we received from the Interpretations Committee at the July 2012 was that the measurement approach should be as consistent with the current measurement approach in IAS 19 as possible. We therefore do not believe that these four approaches should be considered further.

Discount rate used

12. In this part we will be focusing on the first issue, the problem with using the discount rate required by IAS 19 in present valuing the benefit to be received when calculating the net benefit obligation. In the next part we will be dealing with the 'higher of option'.

13. The problem with the discount rate used, when applying the projected unit credit method to measure the benefit obligation of employee benefit plans with a promised return on contributions or notional contributions, is that it will in most cases not reflect correctly the benefit obligation. The reason for this is that IAS 19 requires the benefit to be projected forward at an expected rate of return on the assets or index and discounted to a present value using the rate specified in IAS 19 (a high quality corporate bond rate). However, unless the benefit is based on the return on high quality corporate bonds, that discount rate would not measure the benefits correctly, because the discount rate does not reflect the risk of the assets and the use of any other specific discount rate would result in similar problems.
14. The IASB did acknowledge this problem in its 2008 Discussion Paper *Preliminary Views on Amendments to IAS 19 Employee Benefits*.
15. This problem was also highlighted in the submission on contribution-based promises that prompted the Interpretations Committee to reconsider this issue.
16. Consider the following example. In Year 0 Employer A provides for a contribution in the amount of CU1,000¹ for Employee B. Employer A also guarantees a 4 per cent per year return on the contributions. At the end of Year 25, Employee B receives a post-employment benefit equal to the contributions plus a 4 per cent per year return on the contributions. The contributions are paid into a fund that is expected to generate the guaranteed return of 4 per cent per year. Consequently, at the end of Year 25 Employee B receives a post-employment benefit that consists of the contributions made plus the guaranteed return of 4 per cent per year on the contributions.
17. In accordance with IAS 19, the benefit obligation for Employer A would be calculated in the following way at the end of Year 0. Assume that the market yield on high quality corporate bonds that IAS 19 requires when determining the present value of the obligation is, in this example 3.5 per cent.
 Projected benefit (PB) at year 25 = $1000 \times (1+4\%)^{25} = 2,666$

¹ In this staff paper, currency units are denominated in 'currency units' (CU).

Present value of benefit (PV) = $2,666 \times (1+3.5\%)^{-25} = 1,128$

This would therefore result in a net defined benefit liability of CU128 at the end of Year 0 (1,128-1,000) and a service cost of CU1,128 in the profit or loss in Year 0, of which CU1,000 is paid into the fund.

18. The result above does however not correctly reflect the obligation of Employer A. It is not until the fund is generating performance that is below the guaranteed rate of return that Employer A has an additional obligation, which exceeds the contributions that Employer A has to make. In the example above, Employer A has only guaranteed a minimum return of 4 per cent per year and as a consequence Employer A's obligation at the end of Year 0 should be 0 instead of the CU128 that is the result of the calculations above. This is because at the end of Year 0 the fund has not performed below the guaranteed rate of return.
19. D9 dealt with this problem for benefit plans with a fixed return by measuring the plan liability for a benefit that depends on future asset returns at the fair value of the assets for which the benefit is specified (regardless of whether they are plan assets or notional assets). No projection forward of the benefits was made and discounting of the benefit was therefore not required. This is different from the measurement approach in IAS 19 which does not consider return on assets when present valuing the post-employment benefit in arriving at the defined benefit liability (assets) and instead uses a high quality bond rate. Under IAS 19 these plans would be classified as defined benefit plans which would mean that the projected credit unit method be used to measure the plan liability.
20. For plans with a combination of a guaranteed return and a benefit that depends on a future asset return, D9 used the fixed variable/approach described above.
21. The measurement approach suggested by the IASB in the 2008 Discussion Paper for contribution-based promises was to measure the liability at fair value assuming that the terms of the benefit promise do not change.

Using a discount rate that reflects the risk of the assets

22. Having considered the problem with using the discount rate required by IAS 19 to discount the benefit to arrive at the present value of the employee benefit, we are

of the opinion that the simplest way to address this problem is to use a discount rate that reflects the risk of the assets funding the liability.

23. This is because by using a discount rate that reflects the return on the assets to present value the benefit, the estimated return on the assets that will ultimately be used to provide the benefit, is taken into account. Our proposal would therefore mean that for the example in paragraph 16 above the same rate would be used to project the benefit and discount it back to present value and would therefore result in a defined benefit liability of 0.
24. This would therefore change the discount rate used when applying the projected unit credit method for employee benefits plans to be covered by this project. This is because these plans would use a discount rate that reflects the return on the assets provided to fund the benefit, instead of using a high quality corporate bond rate required by IAS 19 to discount the benefit.
25. However, the plans that will be included in the Interpretations Committee's current work on employee benefits plans with guaranteed return on contribution or notional contributions are not the only employee benefit plans in which the benefit liability is dependent on the return on the assets provided to fund the plan.
26. There may also be defined benefit plans that are funded, in which the same problem with the discount rate used to present value the benefit would exist. Consequently, an alternative solution could be to address this issue relating to the discount rate on a general basis, instead of only addressing it for some plans, which would be within the scope of the interpretation that the Interpretations Committee is working towards. However, we think that the Interpretations Committee should retain the narrow scope that it agreed to at the September 2012 meeting and not broaden this work to address the discount rate question more broadly. We think that the broader question about discount rates would be better addressed as a part of a future broader project on the measurement basis used in IAS 19..

Staff recommendation

27. On the basis of the analysis above. We think that the simplest way to address the problem in measuring the defined benefit liability, for the plans to be covered by the Interpretations Committee work on employee benefit plans with a guaranteed return on contributions or notional contributions, is to use a discount rate that reflects the risk of the assets (or notional assets) provided to fund the employee benefit when measuring the liability.
28. We do not think that using estimated return on the assets, which may be more dependent on management judgement, outweighs the benefits of getting a better measurement of plan liability. Additionally, replacing the high quality bond rate prescribed by IAS 19 with the estimated return rate in these circumstances is in our opinion justifiable in light our analysis above.

Question for the Interpretations Committee

The staff recommend using a discount rate that reflects the risk of the assets (ie expected return on the assets) or notional assets provided to fund the employee benefit to measure the present value the benefit. Does the Interpretations Committee agree? If not, how should the measurement problem with these plans be addressed?

Measurement of ‘higher of options’

29. The second issue that we believe that the Interpretations Committee needs to address regarding measurement of the plans to be covered by its work is the measurement of the so-called ‘higher of option’. This relates to when the employee is guaranteed the higher of two or more possible outcomes; for example the employee may be guaranteed the higher of a fixed return of 4 per cent or the actual return on the contributions made by the employer.
30. The problem here is that the current IAS 19 does not deal with options when using the projected unit credit method. The projected unit credit method uses point estimates to calculate the expected value of the liability, and thus ignores the value of the option of obtaining the higher benefit if the conditions for the higher

benefit are met. Embedded guarantees and options have a value whose recognition and measurement provides useful information and ignoring the value of any option may underestimate the liability.

31. D9 did not deal with this issue separately, but the measurement of this option would have been included within the variable part of the measurement approach. Some respondents when commenting on D9 in 2005 pointed out that for many plans the split of the liability into the fixed and variable components does not fully account for the employer's obligation as it fails to capture the time value of the option. Other respondents also argued that in the case of a plan that provides the greater of two benefits, the value of the guarantee should be explicitly taken into account in order to be consistent with IFRS 2 *Share-based Payments* and IAS 39 *Financial Instruments: Recognition and Measurement*.
32. The 2008 Discussion Paper had a chapter on benefit promises (plans) in which the promise is the higher of a defined benefit promise and a contribution-based promise.
33. The IASB, when preparing the Discussion Paper in 2008, considered whether a 'higher of' option should be measured at its intrinsic value only, or at its intrinsic value plus its time value. The intrinsic value of the option would be equal to the difference at the end of the reporting period between the liability for the defined benefit promise and the liability for the contribution-based promise. However, measuring the option at its intrinsic value would:
 - ignore the value of any option that is out of the money at the reporting date; and
 - require comparison of two numbers that reflect different measurement approaches (projected unit credit for defined benefit promises and fair value, assuming the terms of the benefit promise do not change, for contribution-based promises).
34. The 'higher of' option is similar to an embedded option written by the employer. Current financial instrument accounting requires entities to measure embedded derivatives, including options, at fair value. Consequently, the IASB considered that the 'higher of' option should be measured at fair value.

35. The IASB also noted that measuring the option at fair value would incorporate both the intrinsic value and the time value of the option, thus better representing the obligation.
36. The Discussion Paper proposal was that an entity should recognise and account for the ‘host’ defined benefit promise in the same way as for any other defined benefit promise. The entity should also recognise the ‘higher of’ option separately. An entity should measure the ‘higher of’ option that is recognised separately from a host defined benefit promise at fair value, assuming the terms of the benefit promise do not change.
37. Although many respondents to Discussion Paper did not comment on the IASB’s proposals for the accounting for an option to receive the higher of a defined benefit or contribution-based promise, many of those who did comment on the proposals were critical of them. Some noted difficulties in measuring the fair value of the higher of option, because the underlying promise is measured using the projected unit credit method, which considers only one outcome. Some would prefer a simpler measure, for example intrinsic value, which would account only for the outcome that was the higher at the reporting date. They argued that the benefits of measuring the option at fair value would not outweigh the time and effort expended. However, others argued that the proposed approach is at least better than the current approach, which does not account for the guarantee at all.
38. We think that the main issue to consider for these ‘higher of options’ is whether the time value of money should be included when valuing the ‘higher of options’. That is, should the option be measured at intrinsic value only or intrinsic value plus time value?
39. Measuring the ‘higher of option’ at intrinsic value only would require that when calculating the post employment benefit, only the options which would give you a higher value would be considered.
40. Measuring the ‘higher of option’ at intrinsic value plus time value of money would require splitting (bifurcating) the liability into the intrinsic value (which would be measured using the IAS 19 approach) and an embedded derivative (the option) which would be measured using IFRS9 or IAS 39.

41. Although measuring the option by including both the intrinsic value and the time value may better represent the obligations, we think that using only the intrinsic value is more appropriate for the Interpretations Committee’s current work, because it is more consistent with the ‘best estimate’ approach that is currently used in IAS 19. Using fair value to measure the ‘higher of option’ would be introducing a new measurement approach to IAS 19, which we do not believe should be done at this point, especially within an interpretation.
42. In addition, measuring the ‘higher of option’ at intrinsic value should be easier to do than measuring it at fair value.

Staff recommendation

43. On the basis of the analysis above, the staff recommend that the ‘higher of option’ should be measured at intrinsic value, which may admittedly ignore the time value of money, but which in our opinion is more consistent with the current measurement approach in IAS 19.

Question for the Interpretations Committee

The staff recommends that the ‘higher of options’ should be measured at its intrinsic value at the reporting date. Does the Interpretations Committee agree? If not, how should the ‘higher of option’ be measured?

Recognition and presentation

44. Staff has also considered the accounting for these plans and does not see any problems applying the principles in IAS 19 to these plans.
45. The application of IAS 19 to the measurement of the pension arrangements within the scope of the Interpretations Committee’s work will result in the following accounting:
- (a) service cost recognised in profit or loss;

- (b) net interest on the net defined benefit liability recognised in profit or loss; and
- (c) remeasurements of the net defined benefit liability recognised in other comprehensive income.

46. The proposed requirement to measure the ‘higher of option’ at intrinsic value is a remeasurement and therefore any changes in the ‘higher of option’ should be recognised in other comprehensive income to be consistent with IAS 19.

47. It should be noted that due to the nature of plans covered by this project we would not expect circumstances to arise where employers would have a net defined benefit assets as all surplus in the plans usually belongs to the employees. In the circumstances where the value of the assets would exceed the defined benefit obligation the value of the ‘higher of option’ would be added to the liability, resulting in a net defined asset of 0.

48. However, should the situation arise that there is a net defined benefit liability the requirements of IAS 19 should apply.

Staff recommendation

49. The staff recommends that the proposed interpretations specifies that all changes in the ‘higher of options’ of the employee benefit plans covered by the interpretations should be recognised in other comprehensive income, which is consistent with IAS 19.

Question for the Interpretations Committee

The staff recommends that the proposed interpretations specifies that all changes in the ‘higher of options’ of the employee benefit plans covered by the interpretations should be recognised in other comprehensive income. Does the Interpretations Committee agree? If not, where should the changes be recognised?

Interpretation and amendment to IAS 19

50. The Interpretations Committee has on this project been working towards issuing an interpretation. Staff thinks that is the most appropriate way forward for this narrow scope project.
51. We think that the measurement of the ‘higher of option’ is an issue that an interpretation can deal with as there are currently no specific requirements on how to measure the ‘higher of option’ in IAS 19.
52. However, the changes that are being suggested in the discount rate used when present valuing the post employment benefit are more than just an interpretation of the current requirements of IAS 19. This is a proposed change to the measurement approach for plans that would fall within the scope of the Interpretations Committee’s work and would therefore require a change to the Standard. We think that the change to the standard should in this case be a consequential amendment resulting from the issuance on an interpretation.
53. The result of this project would therefore most likely be an interpretation which would deal with the scope of plans that would fall within the project and the measurement of the ‘higher of option’. A consequential amendment to IAS 19 would prescribe the discount rate to be used in present valuing the employee benefit for the plans that would fall within the scope of the interpretation.

Staff recommendation

54. Therefore the staff recommends, based on the analysis above, that the this project should be taken forward as an interpretations which would deal with the scope of the employee benefit plans that would fall within it and the measurement of the ‘higher of option’. We also suggest that a consequential amendment be made to IAS 19 to prescribe what discount rate to use in present valuing the employee benefit for the plans that fall within the scope of the proposed interpretation.

Question for the Interpretations Committee

The staff recommends that an interpretation be developed which deals with the scope of employee benefit plans covered and the measurement of the 'higher of option'. In addition to that staff recommends that a consequential amendment be made to IAS 19 prescribing the discount rate to use for plans covered by the interpretation when present valuing the employee benefit. Does the Interpretations Committee agree? If not, how should the project be taken forward?

Appendix–The four measurement approaches discussed in the redeliberations of draft interpretation D9 in 2005. For a further explanation of the approaches see agenda paper 11C for the July 2012 meeting.

Fixed/Variable approach (this approach was used in D9)

1. The fixed/variable approach splits the D9 plan into fixed and variable components. The balance sheet liability is equal to the higher of the fixed or variable components and is calculated net of assets and unrecognised balance sheet items. The components of the defined benefit pension costs are based on the fixed component only and the change in the variable component is included as an additional single expense item.

Modified fixed/variable approach

2. The modified fixed/variable approach also splits the plan into fixed and variable components. However, the calculation of the gross defined benefit obligation is required and the components of the defined benefit pension cost represent the changes in both the fixed and variable components, thus making this approach more consistent with the standard.

Pure deconstruction approach (the approach originally recommended by staff in redeliberations of D9 in 2005)

3. The pure deconstruction approach splits the plan into defined benefit, defined contribution and embedded guarantee components. The derivation of the components of the defined benefit pension cost is required to be consistent with the nature of the entity's risk in respect of each component.
4. This approach was rejected by the Committee in April 2005 because it was deemed to be inconsistent with the measurement requirement of IAS 19, because IAS 19 does not allow the use of different approaches for different components of the entity's obligation. The staff did, however, include this approach in the August 2005 agenda paper for completeness, and also included as an appendix in that paper that suggested changes that would have to be made to IAS 19 for this approach to work.

Modified deconstruction approach (this approach was recommended by staff if the Interpretations Committee would continue its work on D9 in 2005)

5. The modified deconstruction approach also splits the plan into defined benefit, defined contribution and embedded guarantee components. However, the components of the defined benefit pension costs are calculated in a manner that is consistent with IAS 19.