STAFF PAPER

IFRS Interpretations Committee Meeting

November 2012

Project	**IAS 19 *Employee Benefits*—Discount rate**		
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Introduction

1. In October 2012, the IFRS Interpretations Committee (the Interpretations Committee) received a request for guidance on the determination of the rate used to discount post-employment obligations. In particular, the submitter asked the Interpretations Committee to interpret the term 'high quality corporate bonds' (HQCB).

2. We performed outreach on this topic with the IASB's Employee Benefits Working Group (EBWG), the International Actuarial Association (IAA), national accounting standard-setters and regulators. The results of this outreach are included as part of the staff's analysis of this issue.

3. The submission is reproduced in full in Appendix B to this paper.

Objective

4. The objective of this paper is to:
   (a) provide background information on the issue raised in the submission;
   (b) provide an analysis of the issue, including a summary of the outreach responses received;

(c) present an assessment of the issue against the Interpretations Committee's agenda criteria and the annual improvements criteria;

(d) make a recommendation that the Interpretations Committee should not take this issue onto its agenda; and

(e) ask the Interpretations Committee whether they agree with the staff recommendation.

Background information

5. The discount rate is an important assumption used in measuring defined benefit obligations. Paragraphs 83-86 of IAS 19 (2011) provide the following guidance on the determination of the discount rate.

83 The rate used to discount post-employment benefit obligations (both funded and unfunded) shall be determined by reference to market yields at the end of the reporting period on high quality corporate bonds. In countries where there is no deep market in such bonds, the market yields (at the end of the reporting period) on government bonds shall be used. The currency and term of the corporate bonds or government bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations.

84 One actuarial assumption that has a material effect is the discount rate. The discount rate reflects the time value of money but not the actuarial or investment risk. Furthermore, the discount rate does not reflect the entity-specific credit risk borne by the entity's creditors, nor does it reflect the risk that future experience may differ from actuarial assumptions.

85 The discount rate reflects the estimated timing of benefit payments. In practice, an entity often achieves this by applying a single weighted average discount rate that reflects the estimated timing and amount of benefit payments and the currency in which the benefits are to be paid.

86 In some cases, there may be no deep market in bonds with a sufficiently long maturity to match the estimated maturity of all the benefit payments. In such cases, an entity uses current market rates of the appropriate term to discount shorter-term payments, and estimates the discount rate for longer maturities by extrapolating current market rates along the yield curve. The total present value of a defined benefit obligation is unlikely to be particularly sensitive to the discount rate applied to the portion of benefits that is payable beyond the final maturity of the available corporate or government bonds.

Staff analysis

Description of the issue

6. The submitter states that:

   (a) according to paragraph 83 of IAS 19 the discount rate should be determined by reference to market yields at the end of the reporting period on HQCB;

   (b) IAS 19 does not specify which corporate bonds qualify to be HQCB;

   (c) according to prevailing opinion, listed corporate bonds are considered to be HQCB if they receive one of the two highest ratings given by a recognised rating agency (eg 'AAA' and 'AA' from Standard and Poor's);

   (d) because of the financial crisis, the number of corporate bonds rated 'AAA' or 'AA' (AA-Bonds) has decreased significantly and are traded less frequently. Consequently, single trades could influence market yield more significantly than in the past and eventually distort the observable market rate and in turn distort the discount rate.

7. In the light of the above, the issue is whether corporate bonds with a rating lower than 'AA' can be considered to be HQCB.

8. The general meaning of Standard and Poor's credit rating opinions is summarised below:

   > 'AA'—Very strong capacity to meet financial commitments.
   > 'A'—Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances.

9. The submitter notes that two views exist in practice:

   (a) **View 1—only AA-Bonds are considered to be HQCB**. This is the predominant approach used in practice and it is consistent with guidance in US GAAP.

   (b) **View 2—corporate bonds with a rating lower than 'AA' can be considered to be HQCB**. Those supporting this view claim that there are no significant differences between corporate bonds rated 'AA' and those rated ‘A’. Consequently, ‘A’-rated corporate bonds can be used to determine the discount rate.

10. We will analyse these views in the following paragraphs.

View 1—only AA-Bonds (or higher) are considered to be HQCB

11. Proponents of this view note that:

    (a) IFRSs do not define HQCB;

    (b) Topic 715-20-S99 *Compensation-Retirement Benefits* in the FASB Accounting Standards Codification ®, states that [emphasis added]: ‘*At each measurement date, the SEC staff expects registrants to use discount rates to measure obligations for pension benefits and postretirement benefits other than pensions that reflect the then current level of interest rates.* ***The staff suggests that fixed-income debt securities that receive one of the two highest ratings given by a recognized ratings agency be considered high quality***.’;

    (c) the UK standard FRS17 *Retirement Benefits* states that: ‘…*a high quality corporate bond means a bond that has been rated at the level of AA or equivalent status…’*

    Consequently they think that only AA-Bonds should be considered to be HQCB.

12. They also note that paragraph BC 134 of IAS 19 states that:

> BC134 IASC had not identified clear evidence that the expected return on an appropriate portfolio of assets provides a relevant and reliable indication of the risks associated with a defined benefit obligation, or that such a rate can be determined with reasonable objectivity. Consequently, IASC decided that the discount rate should reflect the time value of money, but should not attempt to capture those risks. Furthermore, the discount rate should not reflect the entity's own credit rating, because otherwise an entity with a lower credit rating would recognise a smaller liability. IASC decided that the rate that best achieves these objectives is the yield on high quality corporate bonds. In countries where there is no deep market in such bonds, the yield on government bonds should be used.

They think that this paragraph and the requirement to use the market yields on government bonds if there is no deep market in HQCB is a clear indication that the

IASB's intention was to eliminate risk premiums as much as possible. As a result, only AA-Bonds are in line with the intention of the IASB.

13. They also think that there are still sufficient AA-Bonds in the market to determine an appropriate discount rate. They therefore do not understand why entities should use bonds with a lower rating if the current method is still eligible. In order to avoid bias entities should use a method that is consistent over time.

View 2—corporate bonds with a rating lower than 'AA' can be considered to be HQCB

14. Proponents of View 2 note that View 1 is largely based on an SEC staff announcement that was made in 1993 (ie nearly 20 years ago). They think that as a result of the financial crisis ratings may be stricter than they were 20 years ago, even if the bond quality has not changed.

15. They note that US GAAP is a national GAAP that has been developed taking into account the US capital market. Capital markets in other jurisdictions are different from the US market (eg they are less deep than the US capital market). Consequently, applying the US GAAP definition of HQCB in other jurisdictions might not necessarily be appropriate.

16. They note that, in deep markets changes in market yields are caused by changes in the expectation of market participants. At present, changes in market yields are caused by the downgrading of an issuer, because the number of AA-Bonds has decreased (especially with respect to long term AA-Bonds). In their view, the discount rate should be influenced only by the expectation of market participants and not by the downgrading of an issuer; because according to paragraph 84 of IAS 19: *the discount rate does not reflect the entity-specific credit risk*.

17. They also think that there are no significant differences between corporate bonds rated 'AA' and those rated 'A', especially in those bonds' default rates and that the additional risk premiums in the market yields of 'A' rated bonds compared with those rated 'AA' is usually insignificant.

18. Consequently, in their view, using market yields of 'A'-rated bonds to determine the discount rate results only in a minor increase in the credit risk premium (included in market yields) but is based on a significantly broader population, especially for long-term corporate bonds; because, at the moment, the number of

long term AA-Bonds is very limited in many capital markets. It is generally preferred to derive the discount rate from a broader population, because it leads to a more reliable discount rate.

Staff analysis and view

19. We think that paragraphs 83-86 of IAS 19 provide sufficient guidance for determining the discount rate. In our view, entities should apply their judgement in determining a rate that complies with this guidance taking into account the characteristics of their capital markets.

20. According to paragraphs 84 and 85 of IAS 19 the discount rate:

    (a) reflects the time value of money but not the actuarial or investment risk;

    (b) does not reflect the entity-specific credit risk;

    (c) does not reflect the risk that future experience may differ from actuarial assumptions; and

    (d) reflects the estimated timing of benefit payments.

    We note that IAS 19 does not specify what grade of bonds should be designated as high quality.

21. Accordingly, we do not think that the Interpretations Committee should specify the minimum rating that should be considered to be HQCB.

22. We also note that in August 2009 the IASB published the Exposure Draft *Discount Rate for Employee Benefits*. This Exposure Draft proposed eliminating the requirement to use a government bond rate if there is no deep market in high quality corporate bonds. However, responses to that exposure draft indicated that the proposed amendment raised more complex issues than had been expected. After considering those responses, the Board decided not to proceed with the proposals but to address issues relating to the discount rate only in the context of a fundamental review [IAS 19 BC139].

23. We think that:

(a) judgement is required in determining the minimum rating that can be considered to be HQCB; and

(b) given the effect that choosing the discount rate will have on the value of defined benefit obligations, an entity should disclose how it has determined the rate (eg using government bonds, considering only AA-Bonds, etc). This is because, according to paragraph 122 of IAS 1 an entity shall disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

Outreach requests

24. We asked IOSCO, ESMA, EBWG, IAA and national standard-setters to provide us with information on whether the issue raised in the submission:

(a) is widespread and has practical relevance; and

(b) indicates that there are significant divergent interpretations (either emerging or existing in practice).

25. We asked the following two questions:

(a) *How common is this issue? If it is common, could you provide us with information that the Interpretations Committee could use to assess how widespread the issue is?*

(b) *In your view, is there diversity in practice in interpreting the term "high quality corporate bonds"? Please describe the predominant approach that you observe in practice.*

Responses from national standard-setters and regulators

26. We received responses from the following 20 jurisdictions: Europe (8), Asia (7), Americas (3), Oceania (1) and Africa (1).

27. In eight jurisdictions the issue is common. In four of them there is widespread diversity in practice and in another three jurisdictions there is some diversity in practice.

28. We understand that in many jurisdictions the predominant approach used in practice is View 1 (ie only AA-Bonds are considered to be HQCB).

29. In 12 jurisdictions the issue is not common. We understand that in many of these jurisdictions the market for corporate bonds is not deep and so government bonds are used in determining the discount rate.

Responses from EBWG and IAA

30. We received 12 responses.

31. Nine respondents noted that the issue is common. Three of them noted diversity in practice.

32. One respondent noted that the issue is highly relevant even though in most countries entities use government bonds for determining the discount rate. This is because the majority of post-employment benefit liabilities reported in accordance with IAS 19 are concentrated in the countries in which HQCB are used.

33. One respondent noted that View 1 is the predominant approach used in its jurisdiction because it is consistent with the US GAAP guidance.

34. Three respondents noted that there is diversity in practice in determining discount rates based on HQCB; however this diversity is principally due to other factors such as: types of AA-Bonds considered, different data providers, different extrapolation techniques used, etc…

Agenda criteria assessment

35. The staff's preliminary assessment of the agenda criteria is as follows:

    (a) *The issue is widespread and has practical relevance.*

    Yes. On the basis of our outreach, we understand that the issue is widespread.

    (b) *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The Committee will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

On the basis of our outreach, we understand that diversity in practice exists. However, we think that this diversity is principally caused by other factors.

(c) *Financial reporting would be improved through elimination of the diverse reporting methods.*

No. We do not think that financial reporting would be improved by interpreting the term 'HQCB'.

(d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*

No. The submission relates to a requirement of IAS 19 where judgement is required. The question is not an interpretation of the standards but an interpretation of the facts and an application of judgement.

(e) *It is probable that the Committee will be able to reach a consensus on the issue on a timely basis.*

No – see above..

(f) *If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The Committee will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the Committee requires to complete its due process.*

Not applicable. The issue does not relate to a current or planned IASB project.

Assessment against the annual improvements criteria

36. The staff's preliminary assessment of the issue against the annual improvements criteria is as follows:

In planning whether an issue should be addressed by amending IFRSs within the annual improvements project, the IASB assesses the issue against the following criteria. All criteria (a)–(d) must be met to qualify for inclusion in annual improvements.

(a) *The proposed amendment has one or both of the following characteristics:*

(i) *clarifying–the proposed amendment would improve IFRSs by:*

- *clarifying unclear wording in existing IFRSs, or providing guidance where an absence of guidance is causing concern.*
- *A clarifying amendment maintains consistency with the existing principles within the applicable IFRSs. It does not propose a new principle, or a change to an existing principle.*

(ii) *correcting–the proposed amendment would improve IFRSs by:*

- *resolving a conflict between existing requirements of IFRSs and providing a straightforward rationale for which existing requirement should be applied, or.*
- *addressing an oversight or relatively minor unintended consequence of the existing requirements of IFRSs.*

A correcting amendment does not propose a new principle or a change to an existing principle.

No. We think that IAS 19 provides sufficient guidance for determining the discount rate.

(b) *The proposed amendment is well-defined and sufficiently narrow in scope such that the consequences of the proposed change have been considered.*

Yes.

(c) *It is probable that the IASB will reach a conclusion on the issue on a timely basis. Inability to reach a conclusion on a timely basis may indicate that the cause of the issue is more fundamental than can be resolved within annual improvements.*

No. The submission relates to a requirement of IAS 19 where judgement is required.

(d) *If the proposed amendment would amend IFRSs that are the subject of a current or planned IASB project, there must be a need to make the amendment sooner than the project would.*

Not applicable. The issue does not relate to a current or planned IASB project.

Staff recommendation

37. On the basis of our technical analysis, we think that IAS 19 does not specify what grade of bonds should be designated as high quality and that management should apply judgement in determining the minimum rating that can be considered to be HQCB. We also think that according to paragraph 122 of IAS 1 an entity shall disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

38. On the basis of our assessment of the Interpretations Committee's agenda criteria and the annual improvements criteria, we recommend that the Interpretations Committee should not take this issue onto its agenda, because IAS 19 provides sufficient guidance for determining the discount rate.

39. Our proposed tentative agenda decision is included in Appendix A of this paper.

Questions for the Interpretations Committee
1. Does the Interpretations Committee agree that IAS 19 does not specify what grade of bonds should be designated as high quality and that management should apply judgement in determining the minimum rating that can be considered to be HQCB? 2. Does the Interpretations Committee agree that according to paragraph 122 of IAS 1 an entity shall disclose the judgements made in determining the discount rate if the decision about the discount rate has a material impact on the financial statements? 2. Does the Interpretations Committee agree with the staff's recommendation that the Interpretations Committee should not take this issue onto its agenda?

4. Does the Interpretations Committee have any comments on the proposed wording for the tentative agenda decision in Appendix A?

Appendix A—Proposed wording for tentative agenda decision

A1 The proposed wording for the tentative agenda decision is presented below.

IAS 19 *Employee Benefits*—Actuarial assumptions: Discount rate

The Interpretations Committee received a request for guidance on the determination of the rate used to discount post-employment obligations. The submitter stated that:

(a) according to paragraph 83 of IAS 19 the discount rate should be determined by reference to market yields at the end of the reporting period on 'high quality corporate bonds' (HQCB);

(b) IAS 19 does not specify which corporate bonds qualify to be HQCB;

(c) according to prevailing opinion, listed corporate bonds are considered to be HQCB if they receive one of the two highest ratings given by a recognised rating agency (eg 'AAA' and 'AA'); and

(d) because of the financial crisis, the number corporate bonds rated 'AAA' or 'AA' has decreased significantly.

In the light of the above, the submitter asked the Interpretations Committee whether corporate bonds with a rating lower than 'AA' can be considered to be HQCB.

The Interpretations Committee noted that according to paragraphs 84 and 85 of IAS 19 the discount rate:

(a) reflects the time value of money but not the actuarial or investment risk;

(b) does not reflect the entity-specific credit risk;

(c) does not reflect the risk that future experience may differ from actuarial assumptions;

(d) reflects the estimated timing of benefit payments.

The Interpretations Committee observed that:

(a) IAS 19 does not specify what grade of bonds should be designated as high quality;

(b) judgement is required in determining the minimum rating that can be considered to be HQCB; and

(c) according to paragraph 122 of IAS 1 an entity shall disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

The Interpretations Committee noted that the question is about application of judgement rather than interpretation of the standard and consequently [decided] not to add the issue to its agenda.