STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**IAS 19 *Employee benefits***
Paper topic	IFRIC Draft Interpretation D9–Discussion paper *Preliminary Views on Amendments to IAS 19 Employee Benefits*

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Introduction

1. In March 2008 the IASB issued the Discussion Paper (DP) *Preliminary Views on Amendments to IAS 19 Employee Benefits*. The DP set out the Board's preliminary views on amendments to IAS 19.

2. The objective of this paper is to give the IFRS Interpretations Committee (the Committee) an overview of the proposal put forward by the IASB in the DP on contribution-based promises and the reactions of constituents to these proposals.

Background

3. The project on IAS 19 was the IASB's response to calls to review the accounting for post-employment benefit promises. The project was limited in scope to the following issues:

   (a) the deferred recognition of some gains and losses arising from defined benefit plans.

   (b) presentation of defined benefit liabilities.

   (c) accounting for benefits that are based on contributions and a promised return.

(d) accounting for benefit promises with a 'higher of' option.

4. The comment period for the DP ended on 26 September 2008 and 150 responses were received. In addition to the comment letters received, the staff of the IASB undertook other outreach activities.

5. The staff presented its preliminary analysis on the responses to the DP to the IASB at its meeting in November 2008. This paper includes the analysis of the responses on contribution-based promises and promises with a 'higher of' option in that paper.

6. After initial analysis of the comment letters the IASB decided at its meeting in January 2009 to work from the proposals in the discussion paper towards two separate exposure drafts, as follows:

   (a) Part 1: Recognition and presentation of changes in the defined benefit obligation and in plan assets, disclosures, and other issues raised in the comment letters that can be addressed expeditiously.

   (b) Part 2: Contribution-based promises, potentially as part of a comprehensive review of pension accounting.

7. The IASB completed Part 1 in 2011 but has not started work on Part 2. Therefore no further work has been done on contribution-based promises since 2009.

8. The IASB's proposals in the discussion paper other than those relating to contribution-based promises were to remove the option to defer the recognition of changes in defined benefit promises and for presentation approaches for defined benefit promises. In an addition to that the IASB proposed a revise the definitions of post-employment and defined benefit plans and use the term 'promise' in these definitions instead of 'plans'.

9. The proposals in the discussion paper relating to contribution-based promises were the following:

   (a) a new definition of contribution-based promises, which would include what previously was considered a defined contribution plan (see paragraph 17 below);

(b) proposals on recognition issues related to contribution-based promises (see paragraph 26 below);

(c) proposals to measure the liability for contribution-based promises at fair value assuming the terms of the benefit promise do not change;

(d) proposals to measure the liability for benefits of contribution based promises in the same way in the payment and deferment phase as in the accumulation phase;

(e) proposals on the disaggregation of changes in the value of the liability for contribution-based promises into service costs and other value changes;

(f) proposals to present in profit or loss the changes in the liability for contribution-based promises and all changes in the fair value of plan assets; and

(g) proposals for the measurement of benefit promises with a 'higher of' option (see paragraph 39).

Staff analysis

Main issued identified

10. Most respondents to the DP were critical about the IASB's proposals for contribution-based promises. Some even stated that the proposals were more problematic than the current requirements. In particular:

(a) the scope of contribution-based promises, as defined in the DP, is too wide. The IASB should restrict the scope to promises that are problematic to account for using IAS 19.

(b) The measurement proposed represents a fundamental change in measurement for many post-employment benefit plans. It would preferable, and possible, to deal with the troublesome promises within the existing framework of IAS 19.

11. Many respondents 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. Of those who commented many criticised the proposals.

    (a) 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.

    (b) 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 argue that the benefits of measuring the option at fair value would not outweigh the time and effort expended.

12. However, others argue that the proposed approach is at least better than the current approach, which does not account for the guarantee.

13. Many comment letters did not comment in detail on the proposals relating to contribution-based promises because they disagreed with the fundamental proposal of creating a new category of promises either at this stage in a short-term project, or at all. They stated that the IASB should not amend the accounting for those promises that are not problematic to account for using IAS 19. Some also believed that the troublesome promises would be better dealt with within the existing framework of a defined benefit plan.

14. Some respondents disagreed with the specific proposals on the measurement of contribution-based promises but agree with the overall scope of the project on the grounds that the problems with the accounting for contribution-based promises have been outstanding for years, and there is a need for clear guidance.

Accounting for benefits that are based on contributions and a promised return (contribution-based promises)

15. The following paragraphs are a more detailed analysis of the comments received on contribution-based promises.

Definition and scope

Proposals in DP

16. The discussion paper defined a new category of contribution-based promises to capture those promises for which the measurement requirements of IAS 19 are difficult to apply.

17. The definition in the discussion paper is as follows:

A definition of contribution-based promises should be introduced as follows:

> A *contribution-based promise* is a post-employment benefit promise in which, during the accumulation phase, the benefit can be expressed as:
>
> (a) the accumulation of actual or notional contributions that, for any reporting period, would be known at the end of that period, except for the effect of any vesting or demographic risk; and
>
> (b) any promised return on the actual or notional contributions is linked to the return from an asset, group of assets or an index. A contribution-based promise need not include a promised return.

18. Question 5 in the DP asked whether the definition captured the right promises to be addressed in this project.

Responses

19. Most constituents agreed that the IASB should amend the accounting for some plans that meet the proposed definition of contribution-based promises. However, most also think that the proposed definition in the DP will include far too many plans. In particular:

    (a) some promises are not troublesome to account for in accordance with IAS 19 and it is not appropriate to change a well-understood methodology in a short-term project. An example would be a promise in which the benefit includes a fixed return on contributions.

(b) some promises are economically similar to defined benefit plans, in particular career average plans with long averaging periods. It is not appropriate to apply such different accounting to promises, which are so similar.

(c) the distinction between promises in IAS 19 is based on risk. The proposals in the discussion paper put together in the contribution-based category promises with risks that are very similar to defined benefit promises and those whose risks are more similar to financial instruments. As a result, the demarcation is unclear and cannot be readily understood.

(d) it is difficult to determine the fair value effect of demographic risk. All promises that include demographic risk should be measured using the projected unit credit method.

20. Some respondents stated that the IASB should abandon altogether its proposals to address the accounting for these troublesome plans. Others think that the IASB should defer developing proposals until it can do so comprehensively for all post-employment benefit promises. However, most agree that it is necessary for the IASB to address at least some of the troublesome promises in its current project.

21. Of those that agree the IASB should address troublesome promises in this project, most state that the IASB should restrict its amendments to a very narrow class of promise, for example, promises that are linked to the actual return on specified assets with no guaranteed minimum return. Others believe that the problems that the IASB is trying to solve could be addressed by guidance on how to apply the existing requirements of IAS 19, rather than creating a new category of promises with a fundamentally different measurement basis.

22. In addition, many respondents raise issues on the detail of how to apply the definition of a contribution-based promise. For example:

(a) the definition relies on the nature of the benefit promise during the accumulation phase. However, it is not clear what the treatment should be if a plan is closed to future accrual (and future salary increases).

(b) should the existence of death and disability benefits provided in the same plan as contribution-based benefits affect the classification?

(c) does the definition include benefit promises based on revaluations to be set by government in the future?

(d) does the definition include benefit promises based on points that are awarded on a basis other than salary, for example performance or negotiation?

(e) does it include benefit promises based on a fixed amount per year of service where that fixed amount is subject to annual renegotiation?

(f) does it include non-pension long term benefits such as long-term disability, sabbaticals, long service bonuses and jubilee benefits?

Extent of change

23. At the start of the project, the staff expected that the contribution-based promise proposals would affect only a limited number of promises. Question 6 asked how many promises were affected by the proposals.

24. It is clear that many more plans are affected than was originally envisaged. The staff was already aware of this when the discussion paper was published. Estimates given by respondents include:

(a) a majority of German plans. At present, 70% of German plans are defined benefit and 30% defined contribution. Under the proposals, 70% would become contribution-based.

(b) all cash balance plans in Switzerland and Belgium, depending on the classification of promises of benefits with a revaluation set by government.

(c) most plans in the Netherlands. Career average or revalued career average plans have been common in the Netherlands for many years and traditional final salary plans are increasingly incorporating a cap on pensionable salary that makes the plan appear more like a fixed or revalued accrual plan for high earners.

(d) one-half of all defined benefit registered plans in Canada are career-average earnings plans and flat-dollar benefit plans, and would be reclassified as contribution-based.

(e) half the plans in the US. One comment letter claims that about 20% of Fortune 500 US companies operate cash balance plans.

(f) nearly 10% of companies in the UK. Respondents commented that such plans were becoming more common.

Defined contribution plans

25. The IASB stated its intention that the accounting for most defined contribution promises should not change as a result of being re-classified as contribution-based. Question 7 asked whether the proposals achieved that. Most constituents agreed. However, some continued to see a benefit in having a clearly specified separate category of promises for which there is no risk to the employer.

Recognition issues

26. Chapter 6 of the discussion paper discussed the following preliminary views:

PV9 An entity should recognise both vested and unvested contribution-based promises as a liability

PV10 An entity should allocate the benefits earned under a contribution-based promise to periods of service in accordance with the benefit formula

PV11 There should be no requirement to recognise an addition amount determined by the benefit that an employer would have to pay when an employee leaves employment immediately after the reporting date.

27. There were relatively few comments disagreeing with these preliminary views. The main issue raised is that there would be different attribution requirements for defined benefit and contribution–based promises, even though there may be little difference in the promises. This is primarily an issue that arises from the scope. Almost all those who raised this issue were also concerned about the inconsistency between the measurement of contribution based and defined benefit promises. Until a consistent treatment of all defined benefit promises is

developed in a longer term project, those respondents opposed creating a new category of promises and treating them differently from defined benefit promises, or advocated restricting the number of promises affected.

Measurement

Proposals in DP

32. The IASB proposed in the discussion paper that the liability for a contribution-based promise should be measured at fair value assuming the terms of the benefit promise do not change.

Responses

33. Questions 9 and 10 asked about the IASB's proposals for the measurement of contribution-based promises, including measurement in the payout and deferment phases. The IASB's preliminary view was that entities should measure the liability for a contribution-based promise at fair value assuming the terms of the benefit promise do not change.

34. A small minority agreed that the appropriate measurement method for contribution-based promises is fair value assuming the terms of the benefit promise do not change. However, most disagreed for the following main reasons:

    (a) they disagreed that credit risk should be included in the measure of any liability.

    (b) while they agreed that credit risk is relevant for certain types of benefit promises that are very similar to financial derivatives, they argue it is too subjective. Therefore they would prefer a consistent discount rate to be specified.

    (c) they believed the measure of a post-employment benefit liability should not incorporate the effect of credit risk because the entity may be able to reduce even past service portions of benefits in some circumstances. They also argued it is illogical to incorporate credit risk in the measure of the liability without also incorporating possibility of changing benefit.

    (d) they disagreed that two different discount rates (risk-free for contribution based promises and AA for defined benefit promises) would apply to post-employment benefit promises that are very similar economically, such as career average and some averaged-final salary promises.

(e) they thought it would be very difficult to determine the demographic risk factor ie the risk that the demographic assumptions used are incorrect.

35. Other issues raised about measurement at fair value assuming the benefit promise does not change were:

(a) more guidance is needed on how to determine the risk adjustments needed to calculate fair value assuming the benefit promise does not change. For instance, some noted that in a plan with shared assets, it would be necessary to fair value the defined benefit promise in order to determine the relevant credit risk for contribution-based promises.

(b) where the benefits in a plan were originally based on final salary, but are now based on career average salary, it would be difficult to separate the benefits between those accrued as final salary benefits and those accrued as contribution-based benefits. There is no obvious basis for the allocation of assets between the final salary and career average parts of such a plan. This would also affect the presentation of expense.

36. Some respondents thought that instead of creating a new measurement basis for a new category of plans, the IASB should modify the requirements by specifying how to apply the projected unit credit methodology for the troublesome plans.

37. Many disagreed with the view that the liability for benefits in the payment and deferment phases should be measured in the same way as they are in the accumulation phase. That could result in the same liability being measured in different ways depending on the way it was accumulated. The way in which a benefit is accumulated does not affect the economics of the liability and should not affect how the liability is measured.

38. Respondents did however not see any additional difficulty in measuring the liability for a contribution-based promise during the payout phase compared to the accumulation phase.

Benefit promises with a ‘higher of’ option

39. The IASB’s proposals for benefit promises with a ‘higher of’ option were set out in chapter 10 of the discussion papers. The proposals were as follows:

> When a post-employment benefit promise is the higher of a defined benefit promise or a contribution-based promise, entities should recognise and account for the 'host' defined benefit promise in the same way as a defined benefit promise and recognise the 'higher of' option separately.
>
> Entities 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.
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> Entities should disaggregate a 'higher of' option that is recognised separately from a host defined benefit promise into a service cost and other changes in value, with both components presented in profit or loss.

40. Many respondents 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 commented criticized the proposals. 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.