# STAFF PAPER

16 July–17 July 2013

## IFRS Interpretations Committee Meeting

| Project | IAS 19 *Employee Benefits* | | |
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| Paper topic | Employee benefit plans with a guaranteed return on contributions or notional contributions | | |
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## Introduction

1. This paper continues the IFRS Interpretations Committee's (the Interpretations Committee) discussion on the accounting for contribution-based promises within the scope of IAS 19 *Employee Benefits*. The purpose of this paper is to confirm the scope agreed by the Interpretations Committee before continuing the discussion on other aspects of the accounting for such promises in later meetings. This paper is structured as follows:

   (a) Background (paragraphs 2 – 10)

   (b) Confirmation of scope (paragraphs 11 – 18)

   (c) Next steps, with an overview of the major remaining issues to be addressed (paragraphs 19 - 21)

   (d) Appendix A— Analysis of how the agreed scope fits various types of benefit promises

   (e) Appendix B—Summary of the Interpretations Committee's discussions to date

## Background

2. In March 2012, the Interpretations Committee received a request to clarify the accounting for contribution-based promises in accordance with IAS 19. The submitter was not asking the Interpretations Committee to address the accounting for contribution-based promises; the submitter noted the complexity of the issue and was therefore seeking clarification on whether the revisions to IAS 19 in 2011 affected the accounting for these promises.

3. The Interpretations Committee tentatively decided not to take the issue to its agenda in May 2012 and confirmed its decision in September 2012, because it observed that the 2011 revisions to IAS 19 did not intend to address elements specific to contribution-based promises.

4. However, the submission considered by the Interpretations Committee in respect of the application of IAS 19 to contribution-based promises raised a broader question about how to account for such pension plans.

5. The Interpretations Committee has previously considered this issue in 2002-2006 in the context of IAS 19 before the IASB's amendments in 2011. In 2004 it published IFRIC Draft Interpretation D9 *Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions*. In November 2006 it decided to refer the issue to the IASB to be included in the IASB's project on post-employment benefits. Although the IASB initially intended to address contribution-based promises in its project, it later decided to defer this work to a future broader project on employee benefits.

6. In the light of the IASB's decision not to address the accounting for contribution-based promises at present and the ongoing concerns about how to account for such pension arrangements, the Interpretations Committee decided to revisit the issue in its May 2012 meeting.

7. The Interpretations Committee deliberated this issue in its July, September and November 2012 meetings. Details of the Interpretations Committee's previous discussions are included in Appendix B of this paper.

### *Summary of tentative decisions to date*

8. The Interpretations Committee tentatively decided that 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.

9. 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.

10. The Interpretations Committee tentatively decided that a combined benefit promise that offers an employee the higher of two benefit promises (the ‘higher of’ option) should be measured at its intrinsic value at the reporting date. The Interpretations Committee also considered the accounting and presentation for the ‘higher of’ option but did not make a decision on the issue.

### Confirmation of scope

11. We acknowledge that the Interpretations Committee already agreed on the scope and was discussing measurement. However, we think it is important to understand the limits of the scope before continuing with a discussion on measurement.

12. In our view, the most important topic for the issue of contribution-based promises is the scope. The effect of this project will be to divide the current set of promises that fall within the single category of defined benefits into two categories (ie defined benefit promises and contribution-based promises), and require different recognition and measurement requirements for the two categories.

13. The IASB has long acknowledged that the recognition and measurement requirements under IAS 19 are inappropriate for some benefit features. However it has consistently found it difficult to identify the set of 'troublesome' promises.

14. To get a better understanding of the boundaries of the proposed scope, we conducted an analysis to see how it would apply to various types of benefit promises, with a comparison to the scope proposed for contribution-based promises in 2008 Discussion Paper. We used the same promises as those used in the Discussion Paper for the purpose of this analysis (see Appendix A of this paper).

15. On the basis of the analysis in Appendix A, the set of promises that would fall within the agreed scope would be quite similar to the set of promises that would fall within the scope of contribution-based promises in the 2008 Discussion Paper. Thus, we are concerned that the agreed scope is not sufficiently narrow for the purposes of an interpretation or a limited scope amendment, especially if an alternative measurement approach is identified for all the promises within the agreed scope. The exclusion of benefit promises with vesting requirements and demographic risk reduce the set, however a significant number of promises will still be affected, including potentially current salary and career average promises.

16. Following the responses to the discussion paper in 2008, the IASB concluded that the scope proposed in that Discussion Paper was too broad and that defining a narrower set of promises to be recognised and measured differently would be

problematic. This is because it would be difficult to find a conceptual distinction between promises that sit on the continuum between defined contribution[1] and traditional final salary defined benefit promises. The dimensions of that continuum include the amount of exposure of the employer to salary risk and the amount of exposure of the employer to other asset return risks (among other features). The 2008 Discussion Paper attempted to distinguish between these two dimensions for the purpose of defining contribution-based promises.

17. However, salary increases and other asset returns or indices (such as inflation) are inter-related and can be difficult to disentangle conceptually. Thus, any distinction made could result in different accounting for promises which are very similar economically. In the IASB's view at that time, the issue should have been addressed more fundamentally through a comprehensive review of the recognition and measurement requirements more generally, rather than for a limited set of promises.

18. From a more practical point of view, attempting to restrict the scope of contribution-based promises could result in capturing some promises which are not viewed as 'troublesome' and not capturing some promises which are viewed as 'troublesome'.

| **Question 1** |
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| Does the Interpretations Committee agree that:<br><br>(1) the staff analysis of applying the scope of the proposal agreed by the Interpretations Committee to various types of benefit promises is in line with the proposed scope it envisaged?<br><br>(2) the proposed scope is sufficiently narrow? |

[1] Indeed, it could be argued that a defined contribution promise is a defined benefit promise for which the benefit is equal to the contribution to be paid each year. Thus, a current salary promise would be equivalent to a defined contribution promise for which the employer withholds payment of the contributions until the end. However, for defined contribution promises, the measurement of service cost would be equivalent to defined benefit accounting if the contribution is paid each year, therefore there is no accounting difference that arises from the distinction.

## Next steps, with an overview of the major remaining issues to be addressed

19. The following represents a preliminary analysis of the issues that the Interpretations Committee will need to address in order to address the accounting for the benefits within the agreed scope. This is presented for information only and will be updated as the project progresses.

20. To address the accounting for contribution-based promises, the Interpretations Committee will need to discuss the following matters:

    (a) Classification of combined benefits (not 'higher of') – An additional matter relating to plans that have features of two or more benefit categories of benefit promise. These features could be defined by the service period (ie one type of plan for the first x years and then another type of plan for the next x years). Refer Example promise 1 in Appendix A.

    (b) Recognition – We understand that the scope currently agreed by the Interpretations Committee excludes promises with vesting conditions, thus promises that could result in unvested benefits would not meet the definition. This narrows the scope of the definition and alleviates the need to set out requirements for unvested benefits (in contrast with the 2008 Discussion Paper). However, the Interpretations Committee may need to consider (or simply confirm) if the attribution of contribution-based promises to periods of service should be in accordance with existing requirements for attribution of defined benefits. This is necessary because recognition and measurement under IAS 19 are inextricably linked.

    (c) Measurement – As noted in previous papers on the subject, the measurement of contribution-based promises as required by IAS 19 by projecting forward to the ultimate cost and then discounting those amounts results in amounts that do not faithfully represent the economics. We have identified the following alternative measurement approaches that might be suitable for the types of promises within the agreed scope (this list is not exhaustive):

(i) An approach consistent with D9, that required entities to measure benefits with a variable return at the fair value of the underlying reference assets or index. D9 required entities to measure benefits with a fixed return using the projected unit credit method.

(ii) An approach consistent with the 2008 Discussion Paper, that required entities to measure all contribution-based benefits at fair value, including benefits with a variable return and benefits with a fixed return.

(iii) An approach similar to the measurement of cash-settled share-based payments in IFRS 2 for promises that are defined by reference to an underlying asset. IFRS 2 requirements for the recognition and measurement of share-based payments are not consistent with IAS 19, however they may be more suitable for the accounting for some troublesome promises that are defined by reference to an underlying asset or index, or with option features.

(iv) Extending the requirements of paragraph 115[2] of IAS 19 to the measurement of any plan assets whose timing and amounts exactly match the timing and amounts of benefit payments. This would be a pragmatic approach for those plans that invest in the underlying reference assets. However, this approach would result in addressing a very narrow set of benefit promises.

(v) For fixed-rate contribution-based promises, an approach consistent with EITF 03-04 on cash balance plans (ie a "traditional unit credit method").

(d) Presentation and Disclosure – IAS 19 requires that defined benefit cost should be disaggregated with different amounts presented in different part of the statement of comprehensive income. The Interpretations Committee will need to determine how the components of service cost,

[2] That paragraph states:

Where plan assets include qualifying insurance policies that exactly match the amount and timing of some or all of the benefits payable under the plan, the fair value of those insurance policies is deemed to be the present value of the related obligations (subject to any reduction required if the amounts receivable under the insurance policies are not recoverable in full).

finance cost and remeasurements should be determined, given other conclusions on recognition and measurement for the benefit promises within the scope of the project. The Interpretations Committee had a preliminary discussion on presentation of changes resulting from the 'higher of' option in November 2012.

(e) Transition.

21. We intend to discuss recognition and measurement in September 2013.

## Appendix A— Analysis of how the agreed scope fits various types of benefit promises

A1. This appendix applies the scope agreed by the Interpretations Committee to the example benefit promises that were included in the IASB's 2008 Discussion Paper.

A2. For reference purposes, below are the proposed definition of contribution-based promises in the Discussion Paper and the definition of defined contribution plans in the current IAS 19.

**Definition of contribution-based promises in the Discussion Paper**

A contribution-based promise is a post-employment benefit promise in which, during the accumulation phase, the benefit can be expressed as:

- 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
- 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.

**Definition of defined contribution plans in IAS 19**

*Defined contribution plans* are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

| Description of example promise | | 2008 DP | | IC proposal | |
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| | | In scope? | Rationale | In scope? | Rationale |
| 1 | The employer promises a benefit equal to:<br>• for the first 15 years of service, a lump sum benefit accumulated as follows: the entity pays contributions of 8 per cent of salary for each year of service and the return on contributions is equal to the return on an equity index.<br>• for the next 15 years' service, a lump | Yes for first 15 years and define d benefit for | This post-employment benefit promise has a contribution-based promise and a defined benefit promise.<br>Account for each | TBD | The plan is a combination of two promises over time.<br>IC will need to discuss whether the overall promise needs to |

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| | sum equal to 3 per cent of final salary for each year of service. | next 15 years | type of promise separately (paragraph 5.6 of the DP). | | be bifurcated |
| 2 | The employer promises to make contributions into a fund of 5 per cent of the employee's salary during the current reporting period for each year of service. The benefit promise at retirement is a lump sum equal to the contributions increased with the compound return on a specified equity index. | Yes | Accumulated contributions known at the end of the reporting period and the return linked to an index. | Yes | Promise is equal to contributions plus a guaranteed return based on a specified equity index. |
| 3 | The employer promises to make contributions into a fund of 5 per cent of the employee's current salary for each year of service. The benefit promise at retirement is a lump sum equal to the contributions paid plus the actual investment returns on those contributions. | Yes | Accumulated contributions known at the end of the reporting period and the return linked to the return from a group of assets (the plan assets) | No | There is not guaranteed return, therefore this is a defined contributions plan<br>(ie the reference assets are the plan assets) |
| 4 | The employer promises to make notional contributions of 5 per cent of the employee's current salary for each year of service. The benefit promise at retirement is a lump sum equal to the notional contributions increased by interest compounded at the rate of each year's return on a specified equity index. | Yes | Accumulated contributions known at the end of the reporting period and the return linked an index. | Yes | Promise is equal to notional contributions plus a guaranteed return based on a specified equity index. |
| 5 | The employer promises to make notional contributions of 5 per cent of the employee's current salary for each year of service. The benefit promise at retirement is a lump sum equal to the contributions plus a fixed return on the contributions of 3 per cent per year. | Yes | Accumulated contributions known at the end of the reporting period and the fixed return. | Yes | Promise is equal to notional contributions plus a guaranteed return of 3 per cent per year. |
| 6 | The employer promises to make notional contributions of 5 per cent of the employee's current salary for each year of service. The benefit promise at retirement is a lump sum equal to the contributions plus a fixed return on the contributions of 0 per cent per year. | Yes | Accumulated contributions known at the end of the reporting period and the fixed return. | Yes | Promise is equal to notional contributions plus a guaranteed return of 0 per cent per year. |
| 7 | The benefit is a lump sum at retirement equal to 5 per cent of the career average of the employee's salary for each year of service. | Yes | Economically the promise provides the same benefit as the benefit in | Yes | Economically the promise provides the same benefit as the benefit in |

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| | | | Promise 6 above. | | Promise 6 above. |
| 8 | The benefit is a lump sum at retirement equal to 5 per cent of the employee's final salary at retirement for each year of service. | No | Typical final salary promises are a defined benefit. | No | The promise contains salary risk. Because promises with salary risk are excluded from the agreed scope this would be a defined benefit plan. |
| 9 | The benefit is a lump sum at retirement equal to 5 per cent of the average of the employee's final three years' salary before retirement, for each year of service. | No | Impossible to draw a distinction between averaging the last year of salary (Promise 8) and averaging the last three years' salary (Promise 9). Both promises are expressed by reference to future salary, and therefore are defined benefit plans. | No | The promise contains salary risk. Because promises with salary risk are excluded from the agreed scope this would be a defined benefit plan. |
| 10 | The employer promises to make contributions into a fund for each year of service. The contribution in each period of service is 5 per cent of the average of the employee's salary in the most recent two years of service. The benefit promise at retirement is a lump sum equal to the contributions paid. | Yes | Accumulated contributions known at the end of the reporting period to which they relate. | Yes | Economically the promise provides the same benefit as the benefit in Promise 6 above. |
| 11 | The benefit is a lump sum benefit at retirement equal to the number of years' service multiplied by 5 per cent of the average of the employee's salary in the most recent (ie final) two years of service. | No | Accumulated contributions not known at the end of the reporting period. The contributions depend on the average salary in the final two years of service. | No | The promise contains salary risk. Because promises with salary risk are excluded from the agreed scope this would be a defined benefit plan. |
| 12 | The employer promises to contribute into a separate fund 5 per cent of the employee's salary for each year of | Yes | Accumulated contributions known at the end | No | There is a guarantee of return and the |

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| | service. The lump sum at retirement, which is equal to the accumulated contributions plus the investment returns they earn, is converted into a pension at a fixed annuity rate (ie the cost of buying a pension is fixed when the promise is made, rather than being determined by the market rates at retirement date). That pension amount is payable in monthly instalments for the life of the retired employee. | | of the reporting period and the return linked to the return from a group of assets.<br>Demographic risk, which is longevity risk in this Promise, does not affect the classification of a benefit promise. | | plan is a DC plan if not for the guarantee. However, the benefit under the plan depends on demographic risk. Therefore it is a defined benefit plan. |
| 13 | The employer promises to contribute CU100,000[3] into a separate fund on the first day of service. The lump sum at retirement is the contribution of CU100,000, plus a fixed return of 0 per cent. The lump sum is converted into a pension at a fixed annuity rate (ie the cost of buying a pension is fixed when the promise is made, rather than being determined by the market rates at retirement date). This generates a benefit of CU1,000 per year for the life of the retired employee. | Yes | Accumulated contributions known at the end of the reporting period and the fixed return linked to the return from a group of assets.<br>Like Promise 12, Demographic risk does not affect the classification of a benefit promise. | No | There is a guarantee of return and the plan is a DC plan if not for the guarantee. However, the benefit under the plan depends on demographic risk. Therefore it is a defined benefit plan. |
| 14 | The employer promises a benefit of CU1,000 per year for each year after the employee retires until his death, regardless of the service period of the employee. | Yes | Promises in which specified amounts that are not dependent on service are paid in regular instalments after retirement are identical to promises such as Promise 13. | No | The plan contains demographic risk. Therefore it is a defined benefit plan. |

[3] Currency amounts are denominated in ‘currency units’ (CU) in this paper.

## Appendix B—Interpretations Committee's discussions to date

### *July 2012 meeting*

B1. The Interpretations Committee was presented with the feedback received on D9 in 2005 and the feedback that the IASB received on its 2008 Discussion Paper *Preliminary Views on Amendments to IAS 19 Employee Benefits*, especially the proposals on contribution-based promises. The Interpretations Committee also discussed issues which had been raised by respondents on the scope of D9 and was presented with measurement options of plans covered by D9, which were developed by staff in 2005. The Interpretations Committee had considered both scope and measurement in its redeliberations on D9 in 2005 without making any decisions on them at that time.

B2. The Interpretations Committee tentatively decided to continue working towards limited scope proposals on accounting for contribution-based promises. The Interpretations Committee also tentatively decided that the scope of the proposals should be similar to the scope of D9, but clarified that an employee benefit plan would fall within the scope of the proposals if the employer has a legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay for all employee benefits relating to employee service in the current and prior periods in respect of:

(a) a promised return on actual or notional contributions; or

(b) any other benefit guarantee based on the value of one or more underlying assets.

B3. The Interpretations Committee acknowledged that the staff would undertake further outreach on scope and measurement and also noted its concern to ensure that the scope of the proposals was sufficiently narrow. The Interpretations Committee also tentatively decided that the scope of its work should include not only post-retirement benefits but also other long-term benefits.

B4. The Interpretations Committee discussed measurement options for contribution-based promises and provided the staff with input for consideration, but did not make any decisions on this issue.

### *September 2012 meeting*

B5. The Interpretations Committee was presented with a summary of the outreach performed by staff on the types of plans that the Interpretations Committee should consider. The outreach confirmed that the staff have identified the major types of plans to be considered. The outreach also confirmed that there is general support among the respondents for addressing the accounting for these kinds of plans, especially because there is divergence in how they are accounted for currently.

B6. The Interpretations Committee tentatively decided that employee benefit plans should fall within the scope of its work if they have the following characteristics

(c) 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;

(d) 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);

(e) there should be a guarantee of return by the employer on the contributions (notional contributions) made;

(f) the benefit under the plans should not be dependent on future events (eg salary changes, vesting or demographic risk); and

(g) the guarantee under the plan may be based on the value of one or more underlying assets.

B7. 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:

(h) a promised return on contributions, actual or notional; or

(i) any other guarantee on contributions, actual or notional, based on the value of one or more underlying assets.

### *November 2012 meeting*

B8. Staff presented the two main issues that they have identified as important when measuring the employee plans that will fall within the scope of the project. These issues are:

(j) what discount rate should be used to calculate the present value of the employee benefit; and

(k) how to measure the 'higher of' option in the employee benefit plans.

B9. On the first issue there is a concern that the application of the requirements of IAS 19 may not faithfully represent the benefit obligation. This is because IAS 19 requires the benefit to be projected forward at the expected rate of return on the "reference" assets or index and discount those projected cash flows to be discounted to a present value using the rate specified in IAS 19 (typically a high quality corporate bond rate). Some think that unless the benefit is defined by reference to the return on the same assets as that discount rate (such as high quality corporate bonds), the measurement of the benefit will not faithfully represent the risk of the assets that the benefit is based on.

B10. The Interpretations Committee did not make a decision on this issue at the meeting and asked the staff to prepare examples illustrating how the proposed measurement approach would apply to different employee benefit plan designs.

B11. The second issue the Interpretations Committee discussed was how to address the measurement of the so-called 'higher of' option. The 'higher of' option 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 four per cent and the actual return on the contributions made by the employer. The main issue is that IAS 19 does not provide guidance on how to measure the value of the option when using the projected unit credit method.

B12. The Interpretations Committee tentatively decided that the 'higher of' option should be measured at its intrinsic value at the reporting date. The Interpretations Committee also considered the accounting and presentation for the 'higher of' option but did not make a decision on the issue.