STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	IAS 19 *Employee Benefits*		
Paper topic	Employee benefit plans with a guaranteed return on contributions or notional contributions - Measurement		
CONTACT(S)	Manuel Kapsis	mkapsis@ifrs.org	+44 (0)20 7246 6930 +44 (0)20 7246 6459

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

Objective

1. The purpose of this paper is to update the IFRS Interpretation Committee (the 'Interpretations Committee') on the alternatives that the staff are considering for the measurement of benefit promises that fall within the agreed scope. The paper includes a preliminary analysis that attempts to limit the number of alternatives that the staff should consider in more detail when developing the proposals further.

2. This paper includes:

   (a) background and previous discussions (paragraphs 3–7);

   (b) staff analysis and recommendation (paragraphs 8–24); and

   (c) update on the next steps (paragraphs 25–27).

Background and previous discussions

Scope

3. In July 2013, 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 *Employee Benefits* (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 (for example, 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.

Measurement

5. In November 2012, the Interpretations Committee discussed 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 employer may promise the employee the higher of a fixed return of four per cent and the actual return on the contributions.

6. The Interpretations Committee tentatively decided that an entity should measure the higher-of option at its intrinsic value at the reporting date. It also considered the accounting and presentation for the higher-of option but did not make a decision on the issue.

7. In November 2012, the Interpretations Committee also asked the staff to prepare examples illustrating how the proposed measurement approaches would apply to different employee benefit plan designs. The staff will bring examples applying the proposed measurement approach to a future meeting.

Staff analysis

8. IAS 19 requires that an entity measures the defined benefit obligation by projecting the defined benefit forward to determine the ultimate cost, attributing that amount to periods of service and then discounting the amounts related to current and prior service. For contribution-based promises, many argue that this method of determining the defined benefit obligation results in an amount that does not faithfully represent the economics.

9. In the staff's view, the Interpretations Committee needs to determine how far it is willing to diverge from the current measurement requirements of IAS 19 in seeking to more faithfully represent those defined benefit promises. At the one extreme, selecting a measurement objective that most faithfully represents the promises within the scope might require a significant departure from the current requirements of IAS 19, thus exacerbating the difference between the requirements for a promise that falls within the scope and one that falls without (the 'boundary effects'). At the other extreme, maintaining an approach too close

to IAS 19 may not improve the accounting for the promises within the scope to the desired degree. Past attempts of the staff, the IASB and the IFRIC have found it difficult to achieve the appropriate balance of the benefits and costs between these two extremes.

10. Based on the above, we have done a preliminary analysis of the alternatives with respect to the following:

    (a) to what extent the approach faithfully represents the underlying economics of the promises within the scope.

    (b) how far the approach departs from the current recognition and measurement requirements for defined benefit promises in IAS 19 (to understand the potential boundary effect for the promises that are at the margins).

    (c) whether the approach is flexible enough to accommodate the variety of different benefit designs that might fall within the proposed scope.

    (d) outlining some of the issues that the Interpretations Committee would need to address in a subsequent meeting if it was to pursue that measurement approach.

11. We have performed a preliminary analysis of the following alternatives that were identified in July:

    (a) D9 (or similar) approach (paragraphs 13–14);

    (b) fair value approach (paragraphs 15–16);

    (c) ‘mirroring’ approach (paragraphs 17–18); and

    (d) insurance contracts approach (paragraphs 19–21).

12. The staff have not performed further analysis on the following alternatives that we identified in July for the following reasons:

    (a) *Traditional unit credit method approach*—an approach consistent with EITF 03-04 on cash balance plans (ie a ‘traditional unit credit method’). In the staff’s view, the Interpretation Committee should not pursue this

approach because it would only address benefit promises with a fixed return and not the troublesome benefit promises with a variable return.

(b) *IFRS 2 approach*—an approach similar to the measurement of cash-settled share-based payments in IFRS 2 *Share-based Payment* 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. In the staff's view, the outcome of this approach based on the promises in the agreed scope would be similar to the fair value approach because benefits with vesting conditions are excluded from the proposed scope.

D9 (or similar) approach

13. An approach consistent with D9 would require entities to measure benefits with a 'variable' return at the fair value of the underlying reference assets and those with a 'fixed' return using the projected unit credit method. Entities would measure benefits that promised the higher of more than one benefit at the intrinsic value.

14. In the staff's view:

(a) the approach proposed in D9 would more faithfully represent some of the benefit promises than others, however the outcome would also depend on how the split between 'fixed' and 'variable' is defined. In the Draft Interpretation published in 2004, that distinction was based on whether the return on contributions was specified by reference to the market rate on a particular asset (or group of assets, such as an index). In effect, this distinction would subdivide the benefit promises within the agreed scope further and apply the existing recognition and measurement requirements to the fixed component and the fair value approach (as described below) for the variable component.

(b) by retaining the IAS 19 approach for the fixed component and by applying the fair value approach to the variable component, the boundary effect of the D9 approach is limited to the distinction between those two components.

(c) as noted in the comment letters to D9, and the subsequent work carried out by the IFRIC and the IASB, it was not clear how benefits that promise a return of both a variable return and a fixed return would be accounted for under the approach. That is, a benefit that promises not one or the other return (as would be the case in a higher of plan), but a composite of both types. Furthermore, it was unclear whether benefits that were defined by reference to inflation or indices other than returns on equity or debt would fall within the fixed or the variable categories.

(d) matters that will need to be addressed if this approach is considered:

(i) further work on the distinction between the fixed and variable components, including whether inflation or other price indices should fall in one or the other. On the one hand, the existing measurement requirements already envisage inflation and wage price changes and risk by requiring salary progression to be included. However, other risks are ignored and it may not be clear where to draw the line between the two components.

(ii) the accounting for promises that include both a fixed and a variable component (for example, a return that is defined as a composite of an asset return plus a fixed margin).

Fair value approach

15. An approach consistent with the 2008 Discussion Paper would require entities to measure all benefit promises that fall within the agreed scope at fair value (excluding own credit risk), including benefits with a variable return and benefits with a fixed return.

16. In the staff's view:

(a) the measurement approach proposed in the 2008 Discussion Paper would faithfully represent the benefit promises and would be consistent with the measurement of any plan assets, thus eliminating issues of accounting mismatches. However, many respondents to the Discussion Paper noted the high cost of performing such a measurement for the broad set of promises that fall within the scope.

(b) as noted in the responses to the Discussion Paper, the boundary effect of the fair value approach would be significant. Benefits that would fall within the scope except for one feature would be subject to a significantly different measurement requirement if that feature did not exist. This is particularly the case for fixed benefits that fall within the proposed scope but that do not depend on salary or other price risk (such as current salary promises or career average promises), in which case the difference between the measurement under IAS 19 and the fair value approach would be quite pronounced.

(c) the fair value approach would be the most flexible and should, in theory, be applicable to a wide variety of promises that fall within the scope. For higher-of promises, the Discussion Paper proposed the intrinsic value instead of measuring the guarantee or option's fair value. Some respondents noted that two promises with different guarantee levels might appear the same if the option value of the guarantee is not taken into account. For example, if one promise guarantees a three per cent return and another a five per cent return, under an intrinsic value approach the amounts reported might be the same if the actual return was seven per cent for both promises. Some respondents suggested that this shortcoming might be addressed through disclosure.

(d) matters that will need to be addressed if this approach is considered:

    (i) analysis of the benefits and costs of the approach, in particular whether the costs of measuring all promises within the proposed scope at fair value is outweighed by the benefits of the better representation of the economics.

(ii) the change might be too great for a limited scope project, or it might be difficult to justify such a major change for a broad set of promises while leaving the accounting unchanged for the remaining.

(iii) understanding the extent of the boundary effect, including examining the difference that arises between the measurements for promises that fall within the margins of the proposed scope (for example, career average plans compared to plans that promise the average of the last 30 years of pay).

Mirroring approach

17. The mirroring approach extends the requirements of paragraph 115[1] of IAS 19 to the measurement of any plan assets that are invested in the assets that are used as the reference in the definition of the benefit promise. Therefore, it would be a pragmatic approach for those plans that invest in the underlying reference assets that are used in the specification of the benefit. An example of this approach would be a benefit that promises a return based on an equity index, and the contributions to the plan are invested in the same equity index. The approach would require the plan assets to be measured the same as the defined benefit obligation (ie as an exception from the fair value measurement requirements of the plan assets).

18. In the staff's view:

(a) the mirroring approach would not faithfully represent the gross amounts of the plan assets and the defined benefit obligation. However, similar to the exception for insured benefits, it would address the specific case where the benefit promises are economically matched with an

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[1] 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).

investment in the underlying assets, and thus would not result in a surplus or deficit.

(b) this approach would be an exception that would only apply in the limited circumstances where the entity invests in the assets used to define the benefit. In addition, the approach requires the measurement of the assets to be adjusted, and does not introduce a new measurement for the defined benefit obligation. Thus, such an approach would not be a significant departure from IAS 19.

(c) this approach would not be flexible enough to apply to a broad range of benefit promises.

(d) the Interpretations Committee would need to consider how the approach would apply to the higher-of promises.

Insurance contract approach

19. An insurance contract approach is consistent with the measurement requirements that were proposed in the IASB's recent Exposure Draft *Insurance Contracts*. It would require the benefit promise to be measured using an expected value approach that would be consistent with observable market information. That measurement approach would also require an entity to use a discount rate that reflects the dependence of estimated future cash flows on returns on underlying items.

20. The Exposure Draft also proposes an exception to the measurement of the liability if a contract requires the entity to hold underlying items and specifies a link to returns on those underlying items. The staff understand that the objective of that exception is to eliminate the mismatch between the measurement of the asset and the liability. The exception requires the entity to measure the liability by mirroring the asset measurement (in contrast to the mirroring approach that mirrors the liability measurement), as the asset may fall under an IFRS that does not require a fair value measurement. Thus, in the staff's view, the exception would be less relevant for the benefit promises within the proposed scope because IAS 19 requires entities to measure plan assets at fair value.

21. In the staff's view:

    (a) the measurement approach proposed in the Exposure Draft would faithfully represent the benefit promises within the agreed scope. However, like the fair value approach, the staff expect that the cost of performing an expected value measurement for the broad set of promises that fall within the scope would be quite high.

    (b) similar to the boundary effect of the fair value approach, the accounting for benefits that fall within the agreed scope would be quite different to the accounting under existing IAS 19.

    (c) the insurance contract approach would be quite flexible and should be applicable to a wide variety of promises that fall within the scope.

    (d) in addition to the matters that might need to be considered for the fair value approach, the Interpretations Committee would have to reconsider its conclusion on the higher-of promises, because the measurement of the entire promise would be based on an expected value. Furthermore, the staff would have to examine whether the approach would have to be modified to address specific differences between insurance and employee benefits.

Conclusion

22. In the staff's view, applying either the fair value approach or the insurance contracts approach to all the promises in the agreed scope would be a major change, perhaps beyond a limited scope amendment. In contrast, the mirroring approach may be too narrow and may not address the accounting for the plans that are troublesome.

23. An approach based on the fixed/variable distinction of D9 might strike the best balance between the competing objectives of the project. However, attempting to address some of the issues with the D9 approach in the past led the IASB to the fair value approach in the 2008 Discussion Paper. Therefore, in addressing the same matters in subsequent meetings the Interpretations Committee might need to accept some level of inconsistency (and a consequential boundary effect) in order

to avoid running into the same obstacles as the IASB in the lead up to the 2008 Discussion Paper. Having said that, the staff expect that the boundary effect arising from the fixed/variable distinction within the D9 approach should be smaller than the boundary effect arising from applying the fair value approach to all benefits within the agreed scope.

24. If the Interpretations Committee agrees with the staff that it should pursue an approach similar to D9, the staff will provide at a future meeting an analysis of the application of that approach to the same types of promises that it used to illustrate the application of the scope in the July 2013 meeting.

Question 1
Does the Interpretations Committee agree with the staff's proposed direction with regards to the measurement of benefit promises that fall within the agreed scope? If not what measurement approach (or approaches) would the Interpretations Committee prefer the staff examine in more detail at a future meeting?

Update on next steps

25. 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.

26. As noted in the staff analysis, the staff intend to bring a more detailed analysis of the D9 measurement approach to the November 2013 meeting. That analysis will include an illustration of the fixed/variable distinction and the resulting measurement applied to the same types of promises that it used to illustrate the application of the scope in the July 2013 meeting.

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

    (a) classification of combined benefits (not higher-of)—an additional matter relating to plans that have features of two or more categories of benefit promise depending on the number of years of service. For

example, one type of benefit promise for the first 10 years and then another type for the next 10 years.

(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) presentation and disclosure—IAS 19 requires that the defined benefit cost should be disaggregated, with different amounts presented in different parts of the statement of comprehensive income. The Interpretations Committee will need to determine how the components of service cost, 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 the presentation of changes resulting from the higher-of option in November 2012, however further work will need to be done after a measurement approach is decided on.

(d) transition.