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Project Summary

IFRS Accounting Standards

Pension Benefits that Depend on Asset Returns



Project Summary

This document summarises the research findings and the decision of the International Accounting Standards Board (IASB) on its project on Pension Benefits that Depend on Asset Returns.

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At a glance

Between 2018 and 2021 the IASB researched the feasibility of amending IAS 19 *Employee Benefits* in relation to pension benefits that depend on asset returns. Such benefits depend on the performance of specified assets, such as shares or bonds (reference assets).

The IASB researched an approach that would cap the estimated cost of providing this type of pension benefit by applying the discount rate required by IAS 19 (as opposed to the expected rate of return on the reference assets) when that discount rate is lower than the expected rate of return on the reference assets (capped approach).

The IASB's decision

The IASB decided not to develop amendments to IAS 19 because its research did not find enough evidence of pension benefits that depend on asset returns being widely offered across jurisdictions. Therefore, the IASB concluded that the cost of implementing changes outweighed the potential benefit of improved financial reporting. Furthermore, the IASB was mindful of introducing an approach that would require an exception to the measurement requirements in IAS 19.

For more information

More information about the project is available at [IFRS—Pension Benefits that Depend on Asset Returns](#).

Project history

In 2014 the IASB added to its research programme a project to assess whether a solution could be developed for hybrid pension plans without reconsidering the requirements in IAS 19 as a whole. Hybrid pension plans share characteristics of both defined contribution plans and defined benefit plans. The IASB asked for stakeholders' views on this project in the 2015 Agenda Consultation.

Based on the feedback on the 2015 Agenda Consultation, the IASB concluded there was no evidence of problems that were sufficiently widespread and significant to require a comprehensive review of IAS 19. Accordingly, the IASB removed this project from its research programme.

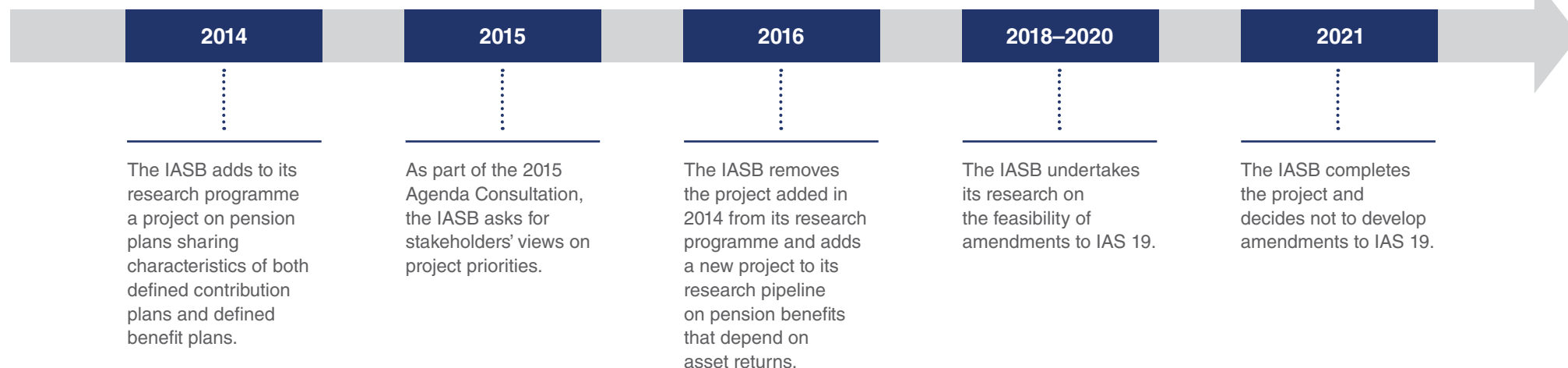
However, simultaneously, the IASB noted that its previous work and the work of the IFRS Interpretations Committee had highlighted an

inconsistency in the measurement of pension benefits that depend on asset returns. For these pension benefits, there is an inconsistency between: (a) the cash flows included in the estimate of the pension benefits; and (b) the discount rate applied to measure the present value of the defined benefit obligation (see page 5 of this Project Summary). To assess whether it would be feasible to develop a solution to eliminate this inconsistency, the IASB decided to add a new project to its research pipeline as part of its [Work Plan 2017–2021](#).

Project timeline

Prior work ...

This project ...



The research question

Scope of the project

As part of its Work Plan 2017–2021, the IASB added to its research pipeline a project to assess whether it would be feasible to eliminate an inconsistency between: (a) the cash flows included in the estimate of the pension benefit that depend on asset returns; and (b) the discount rate applied to measure the present value of the defined benefit obligation.

The project researched those defined benefit plans that grant benefits that depend on the performance of specified assets, such as shares or bonds ('reference assets').

The IASB's research asked if the capped approach would:

- improve financial reporting enough to justify the cost of developing, exposing, finalising and implementing any changes to IAS 19;
- require substantial work from stakeholders or absorb substantial standard-setting resources; and
- have any unintended consequences.

Applying IAS 19 to pension benefits

IAS 19 does not provide requirements that are specific to pension benefits that depend on asset returns. Therefore, an entity applies the requirements in IAS 19 to measure these pension benefits (see page 6 of this Project Summary). The determination of the present value of a defined benefit obligation involves two steps. The entity:

- first, estimates the pension benefit; and
- second, determines a discount rate by reference to market yields of high-quality corporate bonds (IAS 19 discount rate) and applies this rate to discount the estimated pension benefit to measure the present value of the defined benefit obligation.

Outcome of applying IAS 19 to pension benefits that depend on asset returns

The measurement of the present value of a defined benefit obligation results from combining estimated cash flows determined on two bases. The entity:

- estimates the pension benefit by applying the rate of return expected on the reference assets; and
- measures the present value of the defined benefit obligation by applying the IAS 19 discount rate to the estimated pension benefit.

If the expected rate of return on the reference assets is higher than the IAS 19 discount rate, the present value of the defined benefit obligation exceeds the expected cash outflow.

IAS 19 classification and measurement of pension benefits

Classification

An entity applying IAS 19 classifies a post-employment benefit plan as either a defined contribution plan or a defined benefit plan.

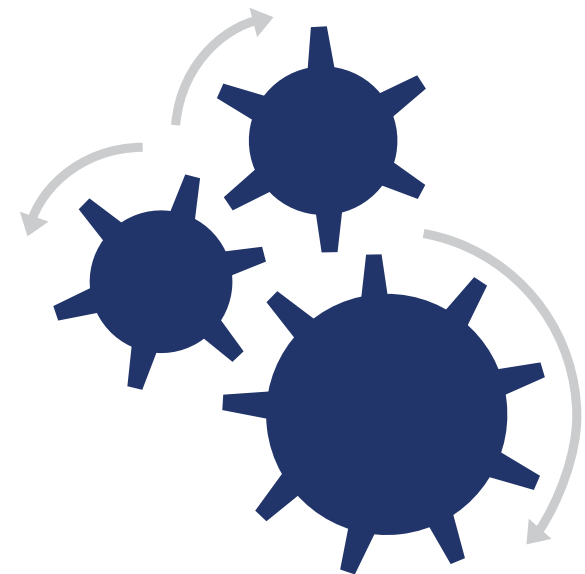
A defined contribution plan is a post-employment benefit plan, under which an entity pays fixed contributions into a separate entity and will have no legal or constructive obligation to pay further contributions if the separate entity does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

Defined benefit plans are post-employment benefit plans other than defined contribution plans.

Measuring the present value of the defined benefit obligation¹

IAS 19 requires an entity to measure the present value of the defined benefit obligation by:

- using an actuarial technique, the projected unit credit method, to make a reliable estimate of the ultimate cost to the entity of the benefit that employees have earned in return for their services in the current and prior periods; and
- discounting that benefit to measure the present value at the reporting date, and the current service cost.



¹ See paragraph 57 of IAS 19 for further information.

IAS 19 classification and measurement of pension benefits *continued ...*

The terms of a defined benefit plan include variables that affect the cost of providing the pension benefit. For example:

- the employer’s contributions (contribution formula) may be a fixed amount or a percentage of the employee’s salary in each year of service;
- the pension benefit (benefit formula) may be a variable return based on a rate, or a fixed benefit based on the employee’s salary in the final year of service; and
- the benefits may be paid (payment period) as a lump sum or converted into an annuity.

Examples of variables that affect the cost of defined pension benefits

Contribution formula		Benefit formula			Payment period	
Level of contribution	Function of salary	Fixed return	Linked to salary	Linked to other variables	Lump sum	Annuity
Stable	Increasing over time		Final salary	Career average	Inflation	Returns on reference assets
						Benefits that depend on asset returns

The research

The capped approach

The IASB researched the feasibility of amending IAS 19 to introduce a capped approach. Applying a capped approach, an entity would estimate the pension benefit by applying the IAS 19 discount rate if that rate is lower than the expected rate of return on the reference assets.

Scenario	How the capped approach would apply	Practical implications
The expected rate of return on the reference assets is higher than the IAS 19 discount rate.	The capped approach would limit (cap) the rate applied to estimate the pension benefit.	An entity would apply the IAS 19 discount rate to estimate the pension benefit and discount the benefit at the same rate to measure the present value of the defined benefit obligation.
The expected rate of return on the reference assets is lower than the IAS 19 discount rate.	The cap would not apply.	An entity would apply the expected rate of return on the reference assets to estimate the pension benefit and discount the benefit at the IAS 19 discount rate to measure the present value of the defined benefit obligation.

An entity applying the capped approach would adjust, at each reporting date, the measurement of the present value of the defined benefit obligation to incorporate the actual return on the reference assets in the reporting period. This adjustment would be needed because, under the approach, the entity would have applied the capped rate to the reference assets (rather than the expected rate of return) to estimate the pension benefit.

continued ...

The research *continued ...*

The capped approach:

- would not have changed the IAS 19 discount rate for pension benefits that depend on asset returns. Feedback on prior consultations demonstrated that it could be difficult to achieve a consensus on a different discount rate.
- could be applied to pension plans that grant a combination of benefits that vary with asset returns and benefits with other characteristics.
- would be consistent with the approach required in IAS 19 to determine the net interest on the net defined benefit liability (asset).

Researching the capped approach

The IASB:

- reviewed information on the frequency of pension benefits that depend on asset returns by jurisdiction. The information did not provide enough evidence that pension benefits that depend on asset returns are widely offered across jurisdictions and, therefore, the cost of implementing changes outweighed the potential benefit of improved financial reporting. Disaggregated data by type of pension benefit was not available.
- considered (at its December 2020 and October 2021 meetings) illustrative examples of the capped approach as applied to various fact patterns to assess whether the approach would require substantial work from stakeholders, absorb substantial standard-setting resources or have any unintended consequences.

The IASB's decision

In October 2021 the IASB considered its research findings.

Although some IASB members supported introducing the capped approach, other IASB members raised concerns that:

- the research did not provide enough evidence of pension benefits that depend on asset returns being widely offered across jurisdictions and therefore that the cost of implementing changes outweighed the potential benefit of improved financial reporting.
- the capped approach would be an exception to the measurement requirements in IAS 19.
- the cost of completing the project could be substantial, due to potential complexities such as:
 - developing presentation and disclosure requirements for the adjustment (see page 8 of this Project Summary); and
 - assessing whether the capped approach should be applied if an entity was exposed to investment risk—that is, when an entity does not hold the reference assets that replicate the pension benefit that depends on asset returns.

Consequently, the IASB decided not to develop amendments to IAS 19.

Illustration of the capped approach

This illustration demonstrates the capped approach, including its effect on the measurement of the present value of the defined benefit obligation and the defined benefit cost in each period. The illustration does not include actuarial differences, including changes in assumptions. The effect of applying the capped approach varies depending on the assumptions made, and on the actual outcomes versus the expected outcomes.

Illustration—terms and conditions of the pension benefit and assumptions

- The benefits are equal to the contributions in the plan formula, increased by the higher of:
 - (a) the returns on the reference assets; or
 - (b) the minimum guaranteed return.
- The benefits are not subject to vesting conditions and are paid as a lump sum at the end of Year 5.
- The contributions are equal to 8% of the employee's salary.
- The salary in Year 1 is equal to CU50,000 and is expected to increase by 2% each year.
- The return on the reference assets is expected to be 4% each year.
- The minimum guaranteed return is 1%.
- The IAS 19 discount rate is 2.5%.
- The contributions are due at the end of the year and the return on the pension benefits starts accruing from that moment.
- Paragraph 70 of IAS 19 does not apply. (Paragraph 70 requires benefits to be attributed on a straight-line basis if the employee's service in later years provides a materially higher level of benefit than in earlier years.)

Table 1—Contributions based on the plan formula

Year	Salary increasing by 2% CU	Contribution to the defined benefit plan CU
1	50,000	4,000
2	51,000	4,080
3	52,020	4,162
4	53,060	4,245
5	54,122	4,330

- As the expected returns on the reference assets are higher than the minimum guaranteed return, the entity estimates the return on the reference assets by applying the expected return of 4% to the opening balance of contributions.

Table 2—Changes in the amount of pension benefits

Year	Opening balance CU	Contribution CU	Returns CU	Closing balance CU
1	—	4,000	—	4,000
2	4,000	4,080	160	8,240
3	8,240	4,162	330	12,732
4	12,732	4,245	509	17,486
5	17,486	4,330	699	22,515

Illustration of the capped approach *continued ...*

Table 3—Expected changes in the present value of the defined benefit obligation

Measurement applying IAS 19					Measurement applying the capped approach					
Year	Opening balance CU	Service cost CU	Interest expense CU	Closing balance CU	Year	Opening balance CU	Service cost CU	Interest expense CU	Adjustment CU	Closing balance CU
1	—	4,239	—	4,239	1	—	4,000	—	—	4,000
2	4,239	4,262	106	8,607	2	4,000	4,080	100	60	8,240
3	8,607	4,285	215	13,107	3	8,240	4,162	206	124	12,732
4	13,107	4,307	328	17,742	4	12,732	4,245	318	191	17,486
5	17,742	4,330	443	22,515	5	17,486	4,330	437	262	22,515

An entity applying the capped approach would:

- determine the service cost by projecting the contribution for the year (for instance, CU4,000 in Year 1) at the capped rate until the date the benefits are expected to be paid to determine the expected benefit, and then discount that expected benefit at the same rate—which results in the same amount. In the example, the contribution is projected at the IAS 19 discount rate because this rate is lower than the expected return on the assets.

- determine the interest expense by multiplying the opening balance of the present value of the defined benefit obligation by the IAS 19 discount rate (for instance, CU4,000 multiplied by 2.5% in Year 2).
- adjust, at each reporting date, the present value of the defined benefit obligation to incorporate the actual returns on the reference assets in the current period (see page 8 of this Project Summary).

If an entity that fully funds the pension benefits and holds the reference assets applies the capped approach, the present value of the defined benefit obligation would be the same amount as the fair value of the reference assets. Therefore, the net pension liability would be nil.

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