IASB Meeting Agenda reference **5A**

Staff Paper Date **July, 2009**

Project	**Post-employment benefits**
Topic	**The discount rate for post-employment benefit obligations**

Purpose of this paper and summary of staff recommendation

1. The purpose of this paper is to ask the Board to eliminate a problem in practice that arises as a result of the IAS 19 requirement concerning the discount rate used to determine the present value the defined benefit obligation.

2. To do this, the staff recommends that the Board:

   (a) amend paragraph 78 of IAS 19 to remove the requirement to use a government bond rate when there is no deep market in high quality corporate bonds (paragraph 17).

   (b) include a reference to guidance proposed in the exposure draft *Fair Value Measurement* for entities estimating a high quality corporate bond rate (paragraph 24).

   (c) that the Board does not fast-track the proposals relating to the discount rate for post-employment benefit obligations.

Background

3. Paragraph 78 of IAS 19 requires the post-employment benefit obligation to be discounted using a rate that is:

> …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

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

> shall be consistent with the currency and estimated term of the post-employment benefit obligations.

4. At its March meeting, the Board considered various issues raised by respondents regarding the discount rate. The Board decided not amend the current requirements related to the discount rate and not to provide any additional guidance relating to the determination of the rate. The Board noted that the project scope did not include a fundamental consideration of the measurement of the defined benefit obligation.

5. In April 2009, at the request of the Board, the staff sent a letter to the Accounting Standards Sub-committee of the International Actuarial Association (IAA) seeking their views on the measurement of defined benefit obligations, in particular on the discount rate that should be applied. The staff noted that these views were sought in the context of an expected comprehensive review of pensions in the future. A copy of this letter is attached as Appendix A.

6. In their response to our letter, the IAA representatives expressed their willingness to work with the IASB on a longer-term solution, but noted that there would be significant benefit if the Board could eliminate a perceived disadvantage for entities in countries with corporate bond markets that were not deemed to be deep. Such entities are required to use a government bond rate, which can be significantly lower in the current market than a high quality corporate bond rate in neighbouring countries with similar economies. Estimates of the impact vary, but some report that a difference of 2% in the discount rate may, in some cases, result in reported liabilities that are 40-60% greater than an equivalent obligation in a neighbouring country. The IAA provided us with an indication of how practice in different countries varies. The full response of the IAA is attached as Appendix B.

7. This paper considers the suggestion in the IAA letter that the Board remove the requirement to use a government bond rate when there is no deep market in corporate bonds by either:

    (a) Simply removing the reference to government bonds and allowing the entity to use its judgement in estimating the appropriate corporate bond rate to use; or

(b) Rewording the requirement to something like: "…where there is no deep market in such bonds, the discount rate should be determined by reference to market yields (at the end of the reporting period) of government and such corporate bonds as are available in the relevant currency, with suitable adjustments for yield spreads observed in similar markets to derive a best estimate for the market yield of high quality corporate bonds."

8. We circulated an earlier draft of this paper to members of the Employee Benefits Working Group and have incorporated their feedback in the staff analysis below.

Staff analysis

9. The IAA views are consistent with the views of other respondents to the Discussion Paper and also with views expressed during meetings of the Employee Benefit Working Group. We described and summarised those views in the discount rate paper presented in March 2009. In that paper, we reported that some constituents argue that it is not appropriate that an entity in an economy that has a deep bond market should be able to measure its liability at a smaller amount than an entity in an economy with an equal risk-free rate but no deep market in corporate bonds.

10. The IAA representatives suggest amending paragraph 78 of IAS 19 to remove the requirement to use a government bond rate when there is no deep market in high quality corporate bonds. Thus, entities would be required to estimate the yield on a high quality corporate bond if one is not directly observable.

11. This section considers:

(a) whether the Board should change the requirements relating to the discount rate; and

(b) what requirements or level of guidance would be appropriate in estimating a high quality corporate bond yield in the absence of an observable yield.

Changing the objective

12. Paragraph 78 of IAS 19 contains two requirements for determining the appropriate discount rate:

    (a) The high quality corporate bond rate is the appropriate rate to use

    (b) If this rate is not observable then entities should use a government bond rate.

13. In the staff's view:

    (a) the absence of a measurement objective in IAS 19 means that there is no conceptual way to select a discount rate.

    (b) paragraph 78 of IAS 19 is inconsistent because it uses two different reference points (a high quality corporate bond when a deep market exists, otherwise a government bond). The government bond is used directly as a target, not as a stepping stone towards a consistent target.

    (c) paragraph 78 of IAS 19 emphasises observability of the discount rate selected, at the expense of comparability between discount rates used by entities in different countries.

    (d) the only reason for the requirement to use a government bond discount rate is to minimise subjectivity in the selection of the discount rate .

    (e) the credit spread (between government bond yields and corporate bond yields) has widened significantly in the last two years. This has considerably increased the effect of the inconsistency caused by the fact that IAS 19 has one objective (high quality corporate bond) in some market conditions and a different objective (government bond) in other market conditions.

14. If the Board were to state that the discount rate is the high quality corporate bond in all circumstances (ie if the Board amended IAS 19 as described in paragraph 9), there would be increased comparability between discount rates used by different entities. The staff believe that defining a single common comparable has the following advantages:

(a) The financial statements will be more comparable across entities and through time for the same entity (as it is possible that an entity using a high quality corporate bond rate in one year could change to a government rate if the market in high quality corporate bonds dries up, or vice versa if a deep market develops). Entities in jurisdictions that have no deep market in high quality corporate bonds would no longer report liabilities that are much higher than equivalent obligations in other jurisdictions and it would reduce the range of rates being used.

(b) There would be no need to assess whether a given corporate bond market is deep.

(c) The requirements will converge to SFAS 87 which does not require the use of a government bond rate when there is no deep market in high quality corporate bonds.

15. However changing the objective has the following disadvantages:

(a) Subjectivity may be increased if entities are required to make significant judgements when estimating the appropriate discount rate.

(b) A high level of subjectivity may impair comparability. For example, it may be difficult to estimate a rate in countries where the economy is not stable. Usually in these countries there is limited or no market information on corporate or even government bonds. In these circumstances estimating the effect of additional risks posed would be highly subjective. However, we note that the current requirements already require subjective estimates of risks in those economies.

(c) Some might regard the information resulting from discounting the liability using a rate that is not attainable in the entity's circumstances as not meaningful.

(d) Entities might incur additional costs in estimating the appropriate discount rate in the absence of an observable rate. Some may feel that these costs are not justified by the benefits, especially if all comparable entities use the government bond rate.

16. The staff also considered arguments that some entities could not estimate a high quality corporate bond rate reliably. However, in the staff's view, entities should be able to estimate a high quality corporate bond rate with no more subjectivity than is required for many other accounting estimates.

17. The Board has already tentatively decided that measurement of the obligation is beyond the scope of this limited scope project. However the staff agrees with the IAA representatives that the Board could make such an amendment as an isolated improvement to resolve current difficulties, without opening up measurement issues generally and without pre-empting any future discussions on the measurement of the defined benefit obligation as part of a comprehensive review. In particular, the staff believes the staff recommendation would merely implement the existing objective (reference to a high quality corporate bond) more consistently and would not pre-empt any future discussion of whether to change that objective.

Staff recommendation
The staff recommends that the Board amend paragraph 78 to remove the requirement to use a government bond rate when there is no deep market in high quality corporate bonds. Instead, the objective should be to estimate the rate for high quality corporate bonds in all cases. Does the Board agree?

What factors to consider when estimating the rate

18. The IAA has suggested including requirements for entities to use observable government and corporate bonds with adjustments for yield spreads observed in similar markets to derive a best estimate.

19. In Agenda Paper 8D of March 2009, the staff argued that there may unintended consequences if entities use the spread between high quality corporate bonds and the risk-free rate in one currency as a basis to value a liability denominated in another currency. The underlying risk-free yield curves would have to be identical in order to avoid substituting one economy's risk for another.

Otherwise the divergence of the yield curves would represent different risk profiles and it would be inappropriate to apply a spread based on one risk profile to a liability with another.

20. The staff believes that the suggested wording provided by the IAA does not simply require taking the spread from another economy without adjustment. Instead the IAA suggestion requires suitable adjustments to derive a best estimate high quality corporate bond rate.

21. However there could be instances where there are no observable yields to use as a reference, for instance where no similar markets are observable. This might occur in economies that are not stable and which are prone to additional risks. In such circumstances, a government bond would normally carry more risk that a high quality corporate bond. The proposal would not provide useful guidance in such instances. In addition, constituents are concerned about the basis of estimating a high quality corporate bond under these circumstances and the inherent subjectivity of adjustments made.

22. One potential option for the Board would be to supplement the IAA's suggested proposal by referring to guidance proposed in the Board's exposure draft *Fair Value Measurement*. This would require entities to apply the principles and approach outlined in the exposure draft to estimate a high quality corporate bond rate using the exit price notion. In other words, entities would derive their estimate of the rate from their estimate of the price that would be received to sell a high quality corporate bond in an orderly market between market participants. Furthermore, the fair value hierarchy would require entities to maximise the use of relevant observable inputs and minimise the use of unobservable inputs in estimating a suitable discount rate.

23. We note that this proposal does not imply that the pension obligation should be measured at fair value, only that an entity would be required to use market participant assumptions in determining a high quality corporate bond rate.

24. The benefits of using such an approach for estimating a high quality corporate bond rate would include the following:

(a) Guidance has already been developed as part of the fair value measurement project. Until that guidance is finalised, entities would refer to existing guidance (for example, in IAS 39).

(b) It will provide a principle based and objective method to estimating the rate.

(c) It will allow entities to apply judgement to take current economic conditions into account that apply to the characteristics of a high quality corporate bond.

(d) It reflects the Board's most recent thinking.

25. However such an approach would have the following disadvantages:

(a) The fair value measurement exposure draft is still open for comment. It may be premature to reference the proposals in a possible fair value measurement standard before they are finalised.

(b) The fair value measurement guidance has not been developed specifically for this application. Valuing a hypothetical high quality corporate bond that does not exist and has no characteristics of its own might be quite different to valuing an existing high quality corporate bond.

Staff recommendation
The staff recommends that the Board includes a reference to guidance proposed in the exposure draft *Fair Value Measurement* for entities estimating a high quality corporate bond rate. Does the Board agree?

Timing of proposed amendment to the discount rate for post-employment benefit obligations

26. The current timetable of the post-employment benefits project envisages a final standard by 2010. However, some constituents have indicated that issues relating to the discount rate are urgent, and suggest that any amendment to the discount rate should be finalised by the end of 2009.

27. In the staff's view, finalising the proposals in this paper as a final standard would not be possible unless the Board issued them as a separate exposure draft with a shortened comment period of two months.

28. We argue that this would not be appropriate because of the additional pressure it would place on constituents to respond to our consultations at a time when the work plan is already full.

Staff recommendation
The staff recommends that the Board does not fast-track the proposals relating to the discount rate for post-employment benefit obligations. Does the Board agree?

Appendix A – Letter sent to the IAA

9 April 2009

Gary Ryan Hibbard
Chairperson, Accounting Standards Sub-Committee
Pensions and Employee Benefits Committee
International Actuarial Association
150 Metcalfe Street, Suite 800
Ottawa, Ontario K2P 1P1
Canada

Dear Mr Hibbard,

Discount rates for defined benefit liabilities

As I am sure you know, the IASB published last year a discussion paper exploring possible improvements to IAS 19 Employee Benefits.

Many respondents to that discussion paper expressed concern about the effect that the choice of discount rate has on the measurement of post-employment benefit obligations. Where there is a deep market in high quality corporate bonds, IAS 19 requires defined benefit post-employment benefit obligations to be discounted by a discount rate that is determined by reference to market yields at the end of the period on high quality corporate bonds. Many have interpreted that requirement to mean the rate on a AA corporate bond index or above. In the current economic climate, this has resulted in a wider than usual range of rates, causing a lack of comparability and, in some cases, higher rates than have recently been used, causing some defined benefit obligations to be reported at what some argue to be artificially low amounts.

We believe that reconsideration of the discount rate is appropriate only in a comprehensive review of how post-employment benefit obligations are measured. In March, the IASB confirmed that it would not be able to add such a comprehensive review to its agenda until after 2011, when it has completed its current programme of revisions to IFRSs.

However, we would like to think ahead and begin to gather material that would be useful to the work we plan to do after 2011. As a result, we would like to seek your help. The Board has not yet discussed how it might address the measurement of defined benefit obligations. We know that makes it difficult to answer questions about the discount rate. However, the Board would like to seek the views of the Accounting Standards Sub-Committee on the following:

1. Does the existing objective for the discount rate in IAS 19 (a high-quality corporate bond) result in relevant information that provides users with a faithful representation of the liability? Why or why not?

2. If fair value were the measurement objective, would it result in more relevant information?
    a. If so, why, and how would you determine the discount rate inherent in fair value?
    b. If not, why not?
3. What other objective(s) should the Board consider, and why?
4. What level of guidance should the Board give on implementing the proposed objectives for the discount rate?

I look forward to hearing from you. I know that the staff on the pensions team would be happy to discuss this request further at their meeting with your representatives on 13 May.

Yours sincerely

Sir David Tweedie

Appendix B – Letter received from the IAA

5 June 2009

Ms Anne McGeachin
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Anne

Many thanks again for the meeting we had with you, Peter Clark and your colleagues on 13 May in London. We felt that the discussion was conducted in an open and constructive atmosphere.

We agreed to get back to you with feedback on both the short and the longer term issues on your agenda.

1. Short term issues

We discussed the practical need to pass a "quick fix" on the subject of the discount rate in countries with corporate bond markets that were not deemed to be deep. The Appendix lists a number of countries categorised according to the general perception of a number of actuarial consulting firms as to how these are typically treated in practice.

In practice, especially as at the year end 2008, we have seen significant differences in discount rates approved by auditors for the purpose of the financial reporting for pension programs in many of these countries. There are at least two reasons for this occurring: First, the view of "deepness" has been subject to different interpretation. Second, the spread of yields on AA bonds has become more disparate, both within that category as well as with reference to other rating categories.

As discussed during our meeting, the divergence in discount rates in established and deep markets as at the year end 2008 was not due to doubts amongst preparing entities as to what reference rate IAS 19 requires but rather due to the high degree of volatility and opaqueness in the markets themselves.

We would therefore suggest simply removing the second sentence in IAS 19.78. This would put IAS 19 on a like footing with the situation prevailing in this area for some years now under US-GAAP, without significant difficulties arising in application in practice. Also you might

consider making a consequential edit to the third sentence to remove the reference to "government bonds".

Alternatively, depending on how prescriptive the IASB wants to be, one could reword the sentence to read (something like): "In countries where there is no deep market in such bonds, the discount rate should be determined by reference to market yields (at the end of the reporting period) of government and such corporate bonds as are available in the relevant currency, with suitable adjustments for yield spreads observed in similar markets to derive a best estimate for the market yield of high quality corporate bonds."

The reasons for making the change include:

- This would remove significant unjustified inconsistency between liability measurement in different currencies.
- It would avoid the current uncertainty as to what constitutes a "deep" market.
- The current default reference, government bond yields, was not greatly different from corporate bond yields at the time of writing IAS 19, when the spread was seldom more than 50 basis points; the spread has widened significantly since September 2007.
- It is consistent in principle with the extrapolation for duration set out in IAS19.81.
- This is not a fundamental change in philosophy to the concept surrounding the discount rate selection and reasonably consistent with approaches applied in other applications. In essence, it is an eminently reasonable "stop-gap" or "quick fix" and no more.

2. Longer term issues

We also discussed the Board's longer term agenda to fundamentally reassess the entire measurement of post employment benefit liabilities. We would be pleased to work with the Board on this. Could we suggest that we arrange a meeting, perhaps with Sir David present, to confirm objectives, timeline and to outline and test our initial thoughts as to how we could assist the Board? We can then formalise a project plan and appropriate resources.

If we could meet relatively soon this would be helpful. We can meet in England, Scotland or another European location if that is more convenient for Sir David.

We look forward to working with you.

Yours sincerely,

Alf Gohdes
Vice-Chair
IAA-PEBS-Accounting Standards Subcommittee

Appendix

The following split of countries / regions is based on the overall perception of some consultants advising multinational companies of typical practice in recent years amongst their clients. It does not purport to be definitive, or represent a thorough survey of general practice.

Typically treated as deep - note these countries account for the bulk of global liabilities:

- Canada
- Eurozone
- UK
- USA

In doubt / mixed practice:

- Japan
- Korea
- Malaysia
- Mexico
- Switzerland

Typically treated as not deep - pretty much everywhere else including:

- Argentina
- Australia
- Brazil
- China
- Colombia
- Hong Kong
- India
- Indonesia
- Morocco
- New Zealand
- Norway
- Pakistan
- Philippines
- Poland
- Singapore
- South Africa
- Sweden
- Taiwan
- Thailand
- Turkey