IASB Meeting | Agenda reference **8B**

Staff Paper | Date **October 2009**

Project **Discount Rate for Employee Benefits**

Topic **Comment Letter Analysis**

Objective of this paper

1. Exposure draft (ED) *Discount Rate for Employee Benefits* was published on 20 August 2009 with a comment period ending on 30 September 2009.

2. The objective of this meeting is for the Board to decide whether to proceed with that proposal. To enable the Board to make this decision we provide:

   (a) an overview of the 100 comment letters we received to the ED,

   (b) an analysis of due process undertaken, and

   (c) an analysis of the responses in the comment letters to the questions in the invitation to comment and the main issues raised.

3. If the Board decides to proceed with the amendment then we discuss further considerations, including the level of guidance to be developed and transition, in Agenda Paper 8C.

4. We have not included in this paper any drafting issues raised by respondents.

Summary of staff recommendations

5. In paragraph 33 we recommend that the Board keep the existing requirement to refer to a government bond rate when there is no deep market in high quality corporate bonds, ie we recommend that the Board does not proceed with the project.

Background

6. The ED proposed short term, limited scope amendments to IAS 19 *Employee Benefits* to remove the requirement to use market yields on governments bonds when there is no deep market in high quality corporate bonds. The amendments were intended to improve the comparability of financial statements by establishing a single objective for the discount rate.

7. This project is not intended to reconsider what the discount rate should be, or to pre-empt any comprehensive review.

Overview of responses

8. We received 100 responses:

Region	Academic	Accounting	Actuarial	Bank	Individual	Preparer	Public	Grand Total
Africa		3	1		1			5
Asia Pacific (excl ANZ)	1	4			3	3		11
Australia/New Zealand	1	3		2		2	4	12
Europe (excl SWE and SWI)	1	12	3	5		6	2	29
Sweden/ Switzerland		2	1	3		5		11
International		7	6			1		14
Middle East			1					1
North America		4	3	1	1	4		13
South America		1	1					2
Unknown					2			2
Grand Total	3	36	16	11	7	21	6	100

9. The responses to the discussion paper were polarised. While a majority of respondents from Europe, North America and International organisations supported the amendment, the majority from the Asia-Pacific Region (including Australia and New Zealand) and emerging markets did not support the amendment. The level of support appears to depend on the proximity of the

respondent to a deep corporate bond market. Entities in parts of Europe outside the Eurozone (eg Sweden and Switzerland) support the amendment as it improves comparability in their economic region. Entities in other parts of the world which have always used a government bond rate do not see the incremental benefit of comparability outweighing the cost of estimating an appropriate discount rate, especially if all neighbouring countries also use government bonds. Many respondents also request that the fair value measurement guidance in IAS 39 *Financial Instruments: Recognition and Measurement* is supplemented by application guidance on how to apply IAS 39 in setting a discount rate or that IAS 19 include stand alone guidance without reference to IAS 39.

10. Finally, on transition, most respondents agreed that prospective application of the proposed amendments is appropriate, but there were mixed views on whether the change would be a change in accounting policy or a change in estimate. The majority of European respondents argued that it was a change in accounting estimate because they believed that the government bond rate was a proxy for the corporate bond rate. Accordingly they think that the effect of the change should be recognised through actuarial gains and losses. The majority of the rest of the respondents agreed with the Board’s conclusion that the change was a change in accounting policy and the amount should be recognised in retained earnings.

Due process requirements

11. Some respondents objected to the ED, arguing that it did not meet the minimum due process requirements set out in the IASB’s due process handbook. Some respondents commented that they do not believe that the matter is exceptionally urgent and they doubt that there is broad consensus on the topic. Others noted their disapproval of the number and speed of changes in recent times and the difficulty for constituents to keep up.

12. We do not agree that the ED did not meet the minimum due process requirements. Paragraph 98 of the IASB Due Process Handbook states that if the matter is exceptionally urgent, the document is short, and the IASB believes that there is likely to be broad consensus on the topic, the IASB may consider a comment period of no less than 30 days. This ED had an exposure period of 40 days, 10 days more than the minimum. Before we issued the ED, our outreach activities had informed us that many constituents perceived this amendment as a desirable short term fix. These consultations indicated that there would not be significant practical problems.

13. We believe that, notwithstanding the shortened comment period, we have received sufficient feedback in the form of 100 comment letters. We believe that we received adequate representation from the jurisdictions most affected, and that this included letters from constituents from emerging markets who do not generally comment on our documents. We therefore think a longer comment period would not necessarily have enabled a wider constituency to comment on our proposals and we believe that the level of analysis in the comment letters indicates that respondents had sufficient time to reach informed conclusions.

14. However we do agree that there is no broad consensus on the topic -some respondents do not consider this to be an urgent issue -and there are more practical problems in some jurisdictions than first envisaged.

Discount rate for employee benefits

15. Question 1 in the Exposure Draft asked:

Question 1 – Discount rate for employee benefits Do you agree that the Board should eliminate the requirement to use government bond rates to determine the discount rate for employee benefit obligations when there is no deep market in high quality corporate bonds? Why or why not? If not, what do you suggest instead, and why?

Respondents' views

16. Many respondents in Europe and North America agreed that the Board should eliminate the requirement to use government bond rates to determine the discount rate for employee benefit obligations. They agreed with the Board's reasoning in BC4:

    (a) that a single objective will improve the comparability in financial statements across entities; and

    (b) that entities in jurisdictions that do not have a deep market in high quality corporate bonds would no longer systemically report liabilities that are higher than equivalent obligations in other jurisdictions

17. However many respondents in other parts of the world objected to the elimination of the requirement to use government bond rates to determine the discount rate for employee benefit obligations. They raised the following concerns:

    (a) The Board has not justified why a high quality corporate bond rate is a superior rate to the government bond rate. Some argue that the Board could also have met the objective of achieving comparability by instead eliminating the requirement to use a high quality bond rate.

    (b) Comparability is not achieved due to the subjectivity of measurement where there is no deep corporate bond market. There is also a wider range of rates within a corporate bond index than for government bonds.

    (c) The Board has not adequately considered issues in emerging markets, including practical issues in estimating a high quality corporate bond yield in economically challenging environments. Some respondents noted that in some instances corporate bonds have a higher rating than government bonds in that economy and that the proposals may have unintended consequences.

(d) The cost involved in deriving a suitable high quality corporate bond rate is high.

(e) The objective of a high quality corporate bond rate lacks clarity, including whether the quality is to be assessed locally or internationally.

(f) The discount rate should only be amended following the Board's comprehensive review of employee benefits. Some argue that the appropriate rate should be the risk-free rate. Amending the rate used now may risk entities having to revert to the original rate in the near future. A few respondents also noted that the credit crisis is not a suitable reason to amend an existing standard that has been in place for many years.

Staff analysis

Appropriateness of a high quality corporate bond rate

18. In paragraph BC7 of the ED the Board stated that it has not yet considered whether the yield on high quality corporate bonds is the most appropriate discount rate for post-employment benefit obligations. The objective of the ED is only to introduce more consistency into the existing requirements.

19. Some respondents would have preferred the Board eliminate the high quality corporate bond rate. These respondents point to paragraph BC31 of IAS 19 which, in their view supports the use of a government bond rate. Paragraph BC 31 states that:

> …the discount rate should reflect the time value of money but should not attempt to capture [the risks associated with a defined benefit obligation]. Furthermore, the discount rate should not reflect the entity's own credit rating, as otherwise an entity with a lower credit rating would recognise a smaller liability…

20. However IAS 19 requires that entities use the government bond rate only if there is no deep market in high quality corporate bonds. The lines immediately following the above quote in paragraph BC31 state that the yield on high quality

corporate bonds is the rate that best achieves the objectives stated in that paragraph. If the Board eliminated the high quality corporate bond rate, it would elevate the government bond rate to the primary objective of the employee benefits discount rate. We do not believe that the Board should change the primary objective as a quick fix amendment.

Improvement in comparability

21. Many respondents challenged the Board's conclusions in paragraphs BC4 that the proposal would reduce the range of rates used thus improving comparability in financial statements. Some argued that the measurement subjectivity would in fact reduce comparability. Others also noted that although the financial crisis has increased the spread between corporate bonds and government bonds, it has also increased the range of rates within high quality corporate bond indices.

22. Whether respondents supported the Board's conclusion that the proposals improve comparability seems to depend upon whether neighbouring countries have been using a high quality corporate bond rate or a government bond rate. We acknowledge that where entities in a country or region currently use a government bond rate, the increased subjectivity in the estimation of a high quality corporate bond may decrease comparability in financial statements within that country or region. However, we still believe that the proposals would increase comparability in financial statements between entities internationally as the objective of the measurement would be consistent.

Emerging market issues

23. We agree with respondents that the proposal would affect entities reporting in economies where the government bonds are not considered high quality or investment grade. Respondents are concerned that we are asking entities in these jurisdictions to do the difficult task of estimating a rate that makes little economic sense as it would not be possible to issue high quality corporate bonds in their jurisdictions. Many respondents believe that the Board should still allow

the use of government bonds when it is difficult for entities to estimate a high quality corporate bond.

24. We agree with respondents that if the Board decides to finalise amendments arising from the exposure draft then it should assist entities in these circumstances by providing IAS 19 specific guidance or additional guidance on how IAS 39 is to be applied. We discuss this issue further in Agenda Paper 8C.

Uncertainty over the objective

25. Respondents have noted that there is uncertainty over the objective of using a high quality corporate bond rate. The current guidance in IAS 19 does not define what a high quality corporate bond is, especially regarding whether the bond needs to be considered high quality from a local or international perspective. While this will have limited effect on those economies where there is a deep corporate bond market or a stable highly rated government, we believe that the issue is important in economies where the government is rated below investment grade. For instance if a government bond is rated BBB then does the 'high quality corporate bond' mean a bond rated much higher than this (the international view) or slightly below this (the local view). This issue is discussed further in Agenda Paper 8C.

Comprehensive review

26. The Board has not yet considered the timing or scope of a comprehensive review of employee benefits. While this will inevitably include a consideration of the discount rate, we do not expect any comprehensive review to begin before 2011.

Staff recommendation

27. We believe the Board has three different alternatives to consider going forward:

    (a) Require government bond rates to be used when it is difficult to estimate a high quality corporate bond rate, rather than when there is no deep market in high quality corporate bonds. The staff would consider further what we mean by ‘difficult’ if the Board decides to proceed on this option.

(b) Continue with the ED proposal to eliminate the requirement to use a government bond rate; or

(c) Keep the existing requirement to refer to a government bond rate when there is no deep market in high quality corporate bonds, ie stop the project.

28. Some respondents have suggested we maintain the use of a government bond rate as either a proxy or a fall-back for entities in economies where government bonds are not highly rated or it is otherwise difficult to estimate a high quality corporate bond. We do not support changing the threshold for using the government bond as it will not achieve the objective of a single discount rate target. Also, any new threshold could face the same problems of interpretation as the IAS 19 threshold and for this reason may require re-exposure.

29. If the Board decides to continue with the proposal to eliminate the requirement to use a government bond rate then the Board will need to decide whether:

(a) to provide additional guidance on the application of IAS 39 in estimating a high quality corporate bond rate; or

(b) to provide specific guidance in IAS 19 on how to estimate a high quality corporate bond rate; and

(c) to provide additional guidance on the characteristics of a high quality corporate bond.

We discuss possible guidance in Agenda Paper 8C.

30. We think that an assessment of the level of guidance needed is relevant in deciding whether to finalise amendments arising from the exposure draft. In particular, we note when the Board developed the exposure draft, it was on the understanding that it would not be able to proceed with final amendments if significant additional material needed to be developed. Depending on the

guidance developed the Board might also need to consider whether re-exposure is required.

31. If the Board decides to go ahead with the proposed amendment and re-exposure is required then we do not believe we would be able to finalise the amendment in time for December 2009 financial statements. However we could re-expose the amendment together with the ED on recognition, presentation and disclosure which is due to be published early next year.

32. We also note that the review of measurement of employee benefits was not originally part of the Board's short term project on employee benefits and we had previously recommended against amending the discount rate without considering measurement of the employee benefit obligation more generally.

33. We therefore recommend that the Board not proceed with the proposed amendment that would have removed the requirement to use market yields on governments bonds when there is no deep market in high quality corporate bonds, ie that the Board does not proceed with the project.

Question
Does the Board agree not to proceed with the proposed amendment that would have removed the requirement to use market yields on governments bonds when there is no deep market in high quality corporate bonds, ie not to proceed with the project?