IASB Meeting Agenda reference **8C**

Staff Paper Date **October 2009**

Project	**Discount Rate for Employee Benefits**
Topic	**Further considerations**

Objective of this paper

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

2. Agenda Paper 8B provided an overview of responses received to the ED, an analysis of responses to question 1 in the ED and a discussion on whether to proceed with publishing an amendment to requirements of IAS 19 relating to the discount rate.

3. In Agenda Paper 8B, we recommended that the Board does not proceed with the amendment. However, we note that if the Board disagrees with the staff recommendation in that paper, we would have limited time to bring issues back to the Board if we still wanted to publish the final amendment in December 2009. We also think that the practical issues of determining the discount rate could affect the Board's decision on whether or not to proceed with the amendment. Accordingly, this paper analyses responses to questions 2 and 3 of the exposure draft. These questions sought comment on the proposed guidance for estimating a suitable discount rate and the transition requirements.

4. This paper also addresses an additional disclosure issue raised by respondents.

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.

Summary of staff recommendations

5. If the Board decides to proceed with the amendment, then we recommend that the Board:

   (a) provides additional guidance in IAS 19 to clarify that an entity should include the time value of money in the currency that the employee benefit is denominated in and the credit risk of a high quality corporate bond issued in that currency (paragraphs 14 -18). However, we recommend that the Board does not provide additional guidance on how these components should be determined.

   (b) retains the proposed references to fair value measurement in IAS 39 and the Fair Value Measurement ED. However, we recommend that the Board provides additional guidance to:

      (i) set the context for the use of the guidance in IAS 39 and the Fair Value Measurement ED in estimating a market yield (paragraphs 20 - 22).

      (ii) clarify that not all the inputs used to estimate a high quality corporate bond rate need to be in the same currency as the post-employment benefit obligation (paragraphs 28 - 30).

      (iii) clarify that the objective of estimating a discount rate is to measure an employee benefit obligation. We also recommend that the Board extend the paragraphs referenced to include paragraph 55 of the Fair Value Measurement ED (paragraphs 31 - 32).

   (c) confirms that additional guidance is not required regarding calibration and liquidity risk when using IAS 39 or the Fair Value Measurement ED to estimate the discount rate (paragraphs 33 - 34).

   (d) confirms the transitional arrangements proposed in the ED (paragraphs 35 - 48).

(e) requires an entity to apply the general requirements in IAS 8 and IFRS 1 to the change resulting from a change in discount rate for employee benefits other than defined benefit obligations (paragraph 49).

(f) requires entities to disclose the method used to determine a high quality corporate bond rate (paragraph 50).

Guidance on determining the discount rate for employee benefits

6. Question 2 in the ED asked:

Question 2 – Guidance on determining the discount rate for employee benefits For guidance on determining the discount rate, do you agree that an entity should refer to the guidance in IAS 39 *Financial Instruments: Recognition and Measurement* for determining fair value[1]? Why or why not? If not, what do you suggest instead, and why?

Respondents' views

7. Some respondents believed that the guidance in IAS 39 and the Fair Value Measurement ED was inappropriate and requested specific, stand-alone guidance be included in IAS 19 (see paragraphs 9 - 10). Other respondents believed that the guidance in IAS 39 and the Fair Value Measurement ED was relevant in terms of the broad objective and principle but that additional guidance would be required to apply the objective and principle to the estimation of a market yield of a high quality corporate bond (see paragraph 11).

8. Both respondents who supported the reference to the fair value guidance in IAS 39 and those who did not requested guidance regarding the characteristics a high quality corporate bond should have. Specifically in economies where the market does not consider government bonds as investment grade, respondents ask if they should assess whether bonds are high quality from a local or international perspective. This assessment could have a significant effect on the discount rate estimated by in these economies.

9. Respondents questioning the appropriateness of the proposed guidance noted the following issues:

[1] In May 2009, the Board published an exposure draft *Fair Value Measurement*. That exposure draft contains proposals to replace guidance on fair value in IAS 39. The Board will update this reference to be consistent with paragraphs 38-54 of *Fair Value Measurement* when it issues an IFRS resulting from the proposals in that exposure draft.

(a) *Estimating a market yield:* Respondents questioned whether the guidance in IAS 39, which deals with determining the value of a particular asset or liability with characteristics of its own, is appropriate for determining the market yield of a basket of hypothetical high quality corporate bonds.

(b) *Subjectivity of measurement:* The IAS 39 fair value guidance is high level and broad and leaves scope for a range of approaches and views on the determination of a discount rate in countries where there is no deep market in corporate bonds.

(c) *Emerging markets:* While the application of the proposed guidance may be straightforward for economies with a strong, stable government, this may not be true for economies where the government bonds themselves are not regarded as high quality. Respondents noted that, in some jurisdictions, there are already issues in establishing a reliable estimate of a government bond rate with the same term as the employee benefit liability and the proposals would exacerbate these issues.

10. Respondents questioning the appropriateness of the proposed guidance either did not support the proposal to eliminate the government bond rate or suggested the following alternatives to the guidance in IAS 39 or the Fair Value Measurement ED:

(a) Formulating specific, standalone guidance in IAS 19 without reference to IAS 39. Examples include something along the lines of the risk-free or government bond rate plus a high quality corporate bond spread derived from global bond markets.

(b) Allowing the use of the government bond rate as a proxy or practical expedient to estimating a high quality corporate bond.

11. Respondents requesting additional guidance to supplement IAS 39 argued that the following areas would require clarification:

(a) *Inputs from foreign markets*: Whether entities could look to other economies for inputs in estimating a high quality corporate bond rate.

(b) *Bid-ask spread*: Whether an entity should estimate the discount rate from the perspective of the high quality corporate bond as an asset or a liability (ie what to do with a bid-ask spread).

(c) *Liquidity risk:* Whether an entity estimating the discount rate needs to include the effect of liquidity.

(d) *Calibration:* Whether an entity needs to calibrate its valuation technique and how it could do this where there is no market.

12. A small number of respondents agreed that having centrally located guidance would improve consistency between standards for the determination of the discount rate but believed that the objective of valuing an asset or liability held is different to the objective of estimating the discount rate. These respondents suggested the Board should consider developing a separate standard on the estimation of discount rates in the same vein as the Fair Value Measurement project.

13. One respondent conceded that using the guidance in IAS 39 raises concerns. However, this respondent does not think that more detailed guidance could effectively address the range of situations and possible approaches that exist in each country and in all market conditions. This respondent advocated the use of formal or informal local groups of industry professionals to discuss and agree on uniform approaches.

Staff analysis

Characteristics of a high quality corporate bond

14. In the past, practice has often equated the characteristics of a high quality corporate bond to, say, an AA rating. However this was in the context of a deep market, and if there was no deep market in AA rated bonds then an entity would use the government bond. Under the current IAS 19 requirements, if the

government bonds in a particular currency are rated below AA, one would not expect to see a deep market in corporate AA bonds in that currency and entities would default to government bonds. However if we require entities to estimate the rate on a high quality corporate bond in a particular currency in all instances, this places additional importance on how entities interpret 'high quality corporate bond'.

15. The yield on a bond represents a number of risks including the time value of money and credit risk among others. The time value of money of a bond denominated in a particular currency represents the broad macroeconomic risks associated with that currency, such as inflation and currency risk. We believe the difference between a corporate bond yield and a government bond yield represents differences in their relative credit risks.

16. Governments bonds in some economies attract a rating lower than investment grade not only because of the risk of default but also because of the effects of high inflation expectations and the risk of devaluation of the currency etc. Respondents ask whether a high quality corporate bond in these situations should include these risks plus any additional amount of credit risk that a high quality corporate would have if it issued a bond in the same local currency. In other words, respondents ask whether they should consider a bond to be a high quality corporate bond if it includes high inflation and currency risk.

17. We think that if the Board were to eliminate the requirement to assess whether there is a deep market in high quality corporate bonds, it needs to clarify what risks an entity should take into account when estimating the discount rate. We set out our recommendation in the following paragraphs. However, we note that any such decision could have a significant effect on the measurements in the jurisdictions affected and has not been exposed for public comment.

18. If the Board decides to discuss whether additional guidance on the characteristics of a high quality corporate bond is required:

    (a) We note that BC31 of IAS 19 states that the discount rate should reflect the time value of money. In our view, this would include the inflation,

currency and other macroeconomic risks that would be present in a government bond rate that is denominated in the local currency. Therefore, if these risks are elevated in a particular economy then the discount rate needs to reflect these risks if it is to properly reflect the time value of money.

(b) Accordingly, a high quality corporate bond rate should reflect the credit risk of a high quality corporate bond issued in that currency. If we instead set the high quality corporate bond rate as an absolute rating (say AA), it might negate part of the effects of inflation and currency risk inherent in the local currency. In the staff's view, that would not meet the objective stated in paragraph BC 31 of the Basis for Conclusions of IAS 19 that the discount rate should reflect the time value of money.

19. Another issue is how an entity in a jurisdiction with below investment grade government bonds can estimate the time value of money. In these jurisdictions the government bond rate will not only reflect the time value of money but also some credit risk. In jurisdictions with market grade government bonds, the credit risk for such bonds is assumed to be negligible and therefore the government bond rate can be used a s a proxy for the time value of money. In jurisdictions with below investment grade government bonds it is difficult to distinguish between the effect of government credit risk and the time value of money. We do not propose the Board provide additional guidance on this issue.

Question 1
Does the Board agree with the conclusion that an entity should include in the determination of the discount rate: (a) the time value of money of the currency that the employee benefit is denominated in; and (b) the credit risk of a high quality corporate bond issued in that currency? Does the Board agree to make this clarification in IAS 19? (It is currently located in the basis.) Does the Board agree not to provide additional guidance on how these components should be determined?

Estimating a market yield

20. We agree with the comments that the objective of the guidance in IAS 39 is to value an individual financial instrument rather than a market yield. However, we believe that this fact does not invalidate the guidance in IAS 39. We believe that the underlying valuation basis should be similar for both individual financial instruments and for market yields. For example, we note that where derivatives based on market yields do not have an active market, an entity can value the derivative using inputs derived from the underlying market. We also note that paragraph 39.72 states that:

> …if a published price quotation in an active market does not exist for a financial instrument in its entirety, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts.

21. However, although paragraph IAS 39.72 would require an entity to determine what the component parts would be, the high quality corporate bond target does not have particular characteristics whose components can be analysed. For example, in the case of a derivative based on an index or a basket of securities

the rules governing the index or the derivative contract itself would clearly define the components.

22. We believe that an entity should use its judgement in determining what corporate bonds to look to and their relative weighting. Entities could view the contents of a basket of corporate bonds and remove statistical outliers. However, we do not think we should provide detailed guidance on how to do this. In the previous section we discuss the issue of what characteristics the high quality corporate bond target implies.

23. Although we believe that the guidance in IAS 39 (and its proposed replacement in the Fair Value Measurement ED) is appropriate to estimate a market yield of a high quality corporate bond, we could add some additional guidance to set an appropriate context. The Board could do this by setting out a summary of the steps an entity could take under the proposed guidance, such as:

    (a) An entity should use any high quality corporate bonds that are observable in the same currency.

    (b) If there are no such corporate bonds, and government bonds are observable in the same currency, then an entity should use a credit spread observed in another economy to estimate the rate using the objectives and principles in IAS 39.

    (c) If no bond rates are available, then an entity should build up the time value of money using the best information available, then use a credit spread observed in another economy to estimate the rate using the objectives and principles of IAS 39.

Question 2
Does the Board agree to provide additional guidance to set the context for the use of the guidance in IAS 39 and the Fair Value Measurement ED in estimating a market yield?

Emerging markets

24. We understand that estimating the discount rate poses challenges in economies that do not have a deep market in government bonds or where the market does not consider the government bonds to be investment grade. Particular problems relate to the availability of inputs and the techniques used to estimate a rate in these circumstances.

25. In our view, IAS 39 already provides guidance that an entity to use a valuation technique that market participants in other economies commonly use. We note the following relevant extracts from IAS 39:

    (a) Paragraph 39.74 states that:

    > If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.

    (b) Paragraph IAS 39.77 states that:

    > …provided there is no change in the credit risk of the debtor and applicable credit spreads after the origination of the debt instrument an estimate of the current market interest rate may be derived by using a benchmark interest rate reflecting a better credit quality than the underlying debt instrument, holding the credit spread constant, and adjusting for the change in the benchmark interest rate

    (c) Paragraph IAS 39.82 may be appropriate for entities in circumstances noted in paragraph 24:

    > *The time value of money (ie interest at the basic or risk-free rate).* Basic interest rates can usually be derived from observable government bond prices and are often quoted in financial publications. These rates typically vary with the expected dates of the projected cash flows along a yield curve of interest rates for different time horizons. For practical reasons, an entity may use a well-accepted and readily observable general rate, such as LIBOR or a swap rate, as the benchmark rate. (Because a rate such as LIBOR is not the risk-free interest rate, the credit risk adjustment appropriate to the particular financial instrument is determined on the basis of its credit risk in relation to the credit risk in this benchmark rate.) In some countries, the central government's bonds may carry a significant credit risk and may not provide a stable benchmark basic interest rate for instruments denominated in that currency. Some entities in these countries may have a better credit

> standing and a lower borrowing rate than the central government. In such a case, basic interest rates may be more appropriately determined by reference to interest rates for the highest rated corporate bonds issued in the currency of that jurisdiction.

26. Even in the absence of a government bond market (in which case the current IAS 19 offers no guidance on how to estimate a discount rate), there is guidance in the Fair Value Measurement ED about the use of unobservable inputs when discussing level 3 inputs in the hierarchy. For example, paragraph 53 states that unobservable inputs shall reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk.

27. While a 'Level 3' type of measurement might increase the level of subjectivity in the measurement, we agree with the view that more detailed guidance could not effectively address the range of situations and possible approaches that exist in each country and in all market conditions. While simple pragmatic guidance, such as the risk-free rate plus an observable credit spread, might work in the majority of situations, we believe that the principles and objectives in IAS 39 and the Fair Value Measurement ED are more appropriate to a larger set of situations.

Question 3
Does the Board agree that it should not develop separate, stand-alone guidance for estimating the discount rate?

Inputs from foreign markets

28. We do not believe that the proposed guidance precludes the use of data from foreign markets, such as using a credit spread derived from a deep corporate bond market denominated in a different currency. We think that some confusion has arisen from paragraph 78 of the ED which states that:

> An entity shall apply the principles and approach in paragraphs AG69-AG82 of IAS 39 *Financial Instruments: Recognition and Measurement* to estimate such rates by reference to yields on high quality corporate bonds denominated in the same currency and whose term is consistent with the currency and estimated term of the post-employment benefit obligations.

29. We agree that the requirement in paragraph 78 is circular in that it requires the application of IAS 39 in estimating a high quality corporate bond rate (of which a market may not exist) by reference to yields on high quality corporate bonds denominated in the same currency and with the same term as the obligation.

30. In our view, the proposed guidance does allow the use of inputs obtained from foreign markets in an appropriate valuation technique. We note that paragraph B3 of the Fair Value Measurement ED lists a 'swap rate based on a foreign-denominated yield curve' as an example of a Level 2 input. Also in paragraph 23 we set out the steps we consider appropriate in estimating a high quality corporate bond which includes the use of inputs from a foreign economy if they are the best available.

Question 4
Does the Board agree that it should clarify that not all the inputs used to estimate a high quality corporate bond rate need to be in the same currency as the post-employment benefit obligation?

Bid-ask spread

31. IAS 39 and the Fair Value Measurement ED have different guidance relating to the bid-ask spread. IAS 39.AG72 states that the appropriate quoted price for an asset held is usually the current bid price and for a liability held the asking price. Under these requirements, the discount rate an entity estimates based on a high quality corporate bond held as an asset could be materially different from the discount rate an entity estimates based on a high quality corporate bond held as a liability. If the Board decides to proceed with the amendment then we recommend clarifying that the objective of estimating a discount rate is to use it in the measurement of a liability.

32. The equivalent requirement in the Fair Value Measurement ED is a little more flexible than the requirement in IAS 39, in that it allows an entity to price within the bid-ask spread at the amount that is most representative of fair value.

Paragraph 55 of the Fair Value Measurement ED allows the use of mid-market pricing as a practical expedient. We do not think additional guidance would be necessary. However, we note that the existing reference in the Discount Rate ED does not include paragraph 55 of the Fair Value Measurement ED, so we recommend extending the reference to this paragraph.

Question 5
Does the Board agree to: (a) clarify that the objective of estimating the discount rate is to measure a liability? (b) extend the paragraphs referenced to paragraph 55 of the Fair Value Measurement ED?

Calibration and liquidity risk

33. The issues raised by respondents regarding their inability to back-test models and how they should take into account liquidity risk in the absence of a market are existing issues and broader in scope than the application of IAS 39 and the Fair Value Measurement ED to the estimation of the discount rate.

34. Consequently, we do not recommend that the Board provides additional guidance regarding calibration and liquidity risk when using IAS 39 or the Fair Value Measurement ED to estimate the discount rate.

Question 6
Does the Board agree that additional guidance is not required regarding calibration and liquidity risk when using IAS 39 or the Fair Value Measurement ED to estimate the discount rate?

Transition

35. Question 3 asked:

> **Question 3 – Transition**
> The Board considered whether the change in the defined benefit liability (or asset) that arises from application of the proposed amendments should be recognised in retained earnings or as an actuarial gain or loss in the period of initial application (see paragraph BC10). Do you agree that an entity should:
>
> (a) apply the proposed amendments prospectively from the beginning of the period in which it first applies the amendments?
>
> (b) recognise gains or losses arising on the change in accounting policy directly in retained earnings?
>
> Why or why not? If not, what do you suggest instead, and why?

Respondents' views

36. Most respondents agreed with part (a), that an entity should apply the proposed amendments prospectively from the beginning of the period in which it first applies the amendment.

37. Responses to part (b) were split. Some held the view that the existing requirement to use a government bond rate was as a proxy for the high quality corporate bond in the absence of a deep market in such bonds. These respondents believe that the elimination of the requirement to use a government bond rate is a change in accounting estimate as an entity used the government bond rate as an estimate of a high quality corporate bond. Therefore, an entity should treat any gain or loss on application of the proposals as an actuarial gain or loss.

38. Others held the view that the existing requirement creates two discount rate targets, depending on the circumstances. These respondents agreed with the Board that a change in the discount rate target entities used because of the elimination of one of the discount rate targets would be a change in accounting policy.

39. A few others agreed with the argument that the change in discount rate is a change in accounting policy but nonetheless believed that the adjustment on application should be treated as an actuarial gain or loss (ie, in effect, as a change in accounting estimate) for a number of reasons:

    (a) Under the existing requirements, an entity would treat a change from a corporate bond rate to a government bond rate (because a deep market emerged or disappeared) as an actuarial gain or loss.

    (b) Many entities have recognised the effect of the divergence of government bonds from corporate bonds as an actuarial gain or loss. Entities should recognise any adjustment arising from the proposals in the same way, to the extent that application of the proposals reverses that effect.

    (c) Some entities in jurisdictions without a deep market in high-quality corporate bonds were estimating a corporate bond rate before the IFRIC rejected that approach in 2005. At the time, these entities processed the adjustment arising from their switch from an estimated corporate bond to a government bond through actuarial gains and losses.

40. Some respondents noted that the transitional requirements did not address where the adjustment should go for employee benefits other than post-employment benefits as the discount rate is used for other long-term employee benefits such as long-service leave.

41. One respondent believed that the Board should consider an approach similar to the treatment of defined benefit obligations in IFRS 1 *First Time Adoption of International Financial Reporting Standards*. Under this approach, an entity has the option to either apply the requirements retrospectively or reset the unrecognised gains and losses to zero on adoption.

Staff analysis

42. We believe that for defined benefit obligations an entity should apply the change in accounting policy prospectively because otherwise the deferred recognition

options could require entities to recalculate the actuarial gains and losses and the resulting deferrals at the end of each reporting period in the past. The staff also believe that the gain or loss resulting from the initial application of the amendment should be adjusted directly through equity because:

(a) it would be consistent with the treatment of other changes in accounting policy; and

(b) it will be recognised separately from other income amounts and changes in accounting estimates.

43. We agree with the views that the initial application of the amendment will result in a change in accounting policy rather than a change in accounting estimate.

44. IAS 8.34 states that changes in accounting estimates result from:

> changes in the circumstances on which the estimate was based or as a result of new information or more experience.

45. IAS 8.35 states that:

> A change in the measurement basis applied is a change in an accounting policy, and is not a change in an accounting estimate.

46. Based on the above we do not agree with the views that the elimination of requirement to use the government bond rate meets the definition of a change in accounting estimate.

47. We note the arguments for recognising the change as an actuarial gain or loss in paragraph 39. However, we note that if the Board regards the change as a change in accounting estimate, then it should also apply a consistent approach to the effect of the amendment on other employee benefits. In those cases, an entity would not recognise the change in accounting estimate as an actuarial gain or loss but would recognise the change in profit or loss. We think the most straightforward approach is to treat all effects of the amendments consistently as a change in accounting policy.

48. We do not believe that Board should consider the approach in IFRS 1 (ie either to apply the requirements retrospectively or to reset the unrecognised gains and losses to zero on adoption) as a possible transition requirement for first time

application because the Board has already decided tentatively to propose the elimination of the deferred recognition option from IAS 19. That proposal will be the subject of a separate exposure draft to be published early in 2010. Requiring entities to recognise any unrecognised gains and losses on initial application of the discount rate amendment might appear as though the Board is accelerating the elimination of deferred recognition for those entities affected by the discount rate amendment.

Question 7
Does the Board re-affirm the transitional requirements proposed in the ED, ie that an entity apply the proposed amendments prospectively from the beginning of the period in which it first applies the amendments and recognise gains or losses arising on the change in accounting policy directly in retained earnings?

49. Regarding employee benefits other than defined benefit obligations that are affected by the change in discount rate, we do not believe that an entity should apply the change prospectively, because the deferred recognition provisions do not affect these amounts. Instead, an entity should apply the general transition requirements in IAS 8 and IFRS 1 because it would not be unduly burdensome for entities to apply the change to the discount rate retrospectively. Although the amendment will change the amounts recognised, entities will not have to recalculate amounts for dates earlier than the date of the beginning of the first period presented in the financial statements. The amounts depend solely on conditions at that date, not on assessments made on previous dates.

Question 8
Does the Board agree that an entity should apply the general requirements in IAS 8 and IFRS 1 to the change resulting from a change in discount rate for employee benefits other than defined benefit obligations?

Additional issues raised by respondents

50. Some respondents requested that entities be required to disclose the technique or approach used to estimate the high quality corporate bond rate. We agree that additional disclosure should be required and would improve comparability of discount rates estimated where there is no deep market in high quality corporate bonds.

Question 9
Does the Board agree to require entities to disclose the method used to determine a high quality corporate bond rate?