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Project	IAS 19 *Employee benefits*		
Paper topic	IFRIC Draft Interpretation D9–Comment letter analysis		
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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*.

Introduction

1. In July 2004 the International Financial Reporting Interpretations Committee (IFRIC) (the previous name for what is now the IFRS Interpretations Committee) issued IFRIC Draft Interpretation D9 *Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions*. This draft interpretation set out proposed accounting requirements for an employee benefit plan with a promised return on actual or notional contributions. A promised return is either a guaranteed return of a fixed amount (or rate)[1] or a promise of a variable return based on specified assets or indices. Such plans could be funded or unfunded and the benefits vested or unvested.

2. The objective of this paper is to give the IFRS Interpretations Committee (the Committee) a broad overview of the comments that were received in response to the draft interpretation. This paper does not therefore include any questions to the Committee.

3. The draft interpretation included only one question, regarding the accounting treatment of changes in the plan liability. Respondents were also invited to comment on any aspect of the draft interpretation.

[1] The minimum fixed return may be a positive return, or it may provide protection against any loss of capital (ie the return will not be less than zero) or against a loss exceeding a fixed minimum loss.

4. The comment period ended on 21 September 2004 and 45 responses were received. The responses are analysed below by region and submitter type.

Submitters by region:

Europe	27	60%
Asia	8	18%
International	4	9%
North America	4	9%
Oceania	2	4%
	45	100%

Submitters by type

Professional organisations	15	33%
Standard-setters	10	22%
Actuary firms	9	20%
Preparers	6	13%
Audit firms	4	9%
Regulators	1	2%
	45	100%

Summary

5. A large majority of respondents supported the use of defined benefit accounting for plans that fall within the scope of the draft interpretation. However, further clarification was requested on the scope of the draft interpretation, and, in particular, on the distinction between defined contribution and defined benefit plans (see paragraphs 11-15 of this paper).

6. A significant minority of respondents disagreed with the proposed measurement requirements in the draft interpretation (paragraphs 16-28).

7. The respondents also had concerns about issues such as convergence with US GAAP and whether it was within the remit of the IFRIC to deal with this issue by issuing an interpretation (paragraphs 30-31).

8. Finally, other issues were raised such as (paragraphs 32-36):

   (a) the treatment of gains and losses, in particular, the application of the corridor method;

   (b) transition requirements;

(c) definitions; and

(d) the examples put forward in the draft interpretation.

Analysis

9. Respondents generally supported the Committee's efforts to clarify the accounting for this kind of employee benefit plans, because such plans are becoming more common and will probably result in increasing numbers of problems for preparers when applying IAS 19 to these plans.

10. The main issues raised in the responses were on the scope and the proposed measurement method in the draft interpretation.

Scope

11. The scope of D9 was set to cover plans with a promised return on actual or notional contributions. Some of the respondents said that the definition of plans to be covered by D9 would make the distinction between such a plan and a defined contribution plan unclear, because a plan that is a defined contribution plan also promises a return on contributions. Consequently, these respondents stated that a further clarification would be needed on the distinction between plans that pass the asset returns on to the employees and plans that expose the employer to risk. This is because in a normal defined contribution plan the benefit received also depends on future asset returns of the plan. In contrast, the plans intended to be covered by the draft interpretation have a return guaranteed by the employer, thereby exposing the employer to additional risk. In a defined contribution plan all the assets return created by the contributions is passed on to the employee, Therefore the employer's obligation ends when he has paid the contribution into the employee's plan.

12. Some respondents also suggested that the term 'promised return' should be defined, because if the return on contributions is promised by a third party (without further recourse to the employer) the plan would not be classified as a defined benefit plan but as a defined contribution plan.

13. Respondents also pointed out that a number of plans promise an increase in benefits that is not linked to the return on any specific assets or the assets which the plan is funded with, eg where the return is linked to an inflation or equity index or is based on some other measure such as corporate performance. Respondents noted that many 'cash balance' plans in the US operate in this manner. They said that it was uncertain whether D9 was intended to apply to such plans.

14. Finally, respondents questioned whether the scope includes other long-term benefits. D9 stated that the interpretation applies to defined benefit plans. The respondents noted that under IAS 19 other long-term benefits are treated in the same way as post-retirement benefits and there seems to be no reason for D9 not to apply to those benefits as well.

The distinction between defined contribution and defined benefit plan

15. Some respondents argued that the definition of a D9 plan implies that the distinction between such a plan and a defined contribution plan was unclear because both plans promise a return on contributions. Other respondents said that it might be unclear as to whether an employer's constructive obligation existed in certain plans, and hence whether the plan was defined benefit or defined contribution. According to comments received, this seems to be an issue for some Swiss plans where asset return smoothing and a minimum guarantee of return may result in a legal or constructive obligation for additional contributions by the employer.

Measurement

16. D9 identifies three categories of promised return:

    (a) a guaranteed return of a fixed amount (or rate) (see paragraph 17).

    (b) a promise of a variable return based on specified assets or indices (see paragraph 18).

    (c) a combination of the promises in (a) and (b) (see paragraphs 19-20)

17. For a guaranteed return of a fixed amount (or rate), D9 proposed that an entity should apply the defined benefit methodology in IAS 19 by:
    (a) calculating the benefit to be paid in the future by projecting forward the contributions or notional contributions at the guaranteed fixed rate of return;
    (b) allocating the benefit to periods of service; [the reference to allocation to periods of service related largely to whether more benefit should be attributed to later periods if the benefits depend on salaries.]
    (c) discounting the benefits allocated to the current and prior periods at the rate specified in IAS 19 [generally a high quality corporate bond rate] to arrive at the plan liability, current service cost and interest cost; and
    (d) recognising any actuarial gains and losses in accordance with the entity's accounting policy. [Item (d) related to the choice between the corridor approach and immediate recognition. This choice is no longer relevant following the amendments made to IAS 19 in 2011.]
18. For a promise of a variable return based on specified assets or indices, D9 proposed that:
    (a) an entity should measure its liability for that promise at the fair value of the assets upon which the benefit is specified (whether plan assets or notional assets[2]), subject to (b) and (c) below. No projection forward of the benefits should be made, and discounting of the benefit would not therefore be required.
    (b) if the benefits are unvested, the measurement of the liability for those benefits shall be determined by the extent to which they are expected to vest in the future.
    (c) if the benefits include a specified margin on future asset returns, when the plan liability is measured the effect of the margin should be added to or deducted from, as appropriate, the fair value of the assets.

[2] Notional assets are assets other than plan assets, as defined in IAS 19, or reference indices.

(d) the change in the recognised defined benefit asset or liability should be presented as a single amount. It should not be analysed into components, for example those representing service cost or interest cost.

19. For a combination of a fixed return and a variable return, D9 proposed a split of the benefit promise into a fixed component (whose amount does not depend on future asset returns and a variable component (whose amount depends on future asset returns). An example is a benefit that applies to contributions the higher of (a) a fixed return of 2% and (b) the actual rate of return on the plan assets. D9 proposed that an entity should measure such a combination by measuring the liability at the sum of the following two amounts:

    (a) the fixed component (measured as in paragraph 17 above), plus

    (b) an additional liability to the extent that the variable component measured as in paragraph 18 above) exceeds the measurement of the fixed component.

20. In essence, the approach described in paragraph 19 analyses such a combined benefit as the sum of:

    (a) the fixed component, and

    (b) a written call option that entitles the plan to call the assets underlying the variable component in exchange for the fixed component. The methodology in paragraph 19 measures that call option at its intrinsic value only, and excludes the time value of that call option.

21. A small number of respondents disagreed fundamentally with the proposed measurement approach. Others disagreed with certain parts of the approach, such as its application when using the corridor method, on attributions of benefits to periods and the treatment of a link to an index or to 'notional' contributions and cash balance plans.

22. The main issues that were raised by respondents and which the staff has identified in respect of the measurement of the obligation are:

    (a) the value of any embedded guarantees/options;

(b) the fixed/variable distinction; and

(c) the appropriateness of a corporate bond yield as the discount rate.

Value of any embedded guarantees/options

23. One of the key issues considered, in D9 in measuring plans that fall within the scope of D9, is the value of guarantees and options. Some respondents pointed out that for many plans the split of the liability into the fixed and variable components does not fully account for the employer's obligation as it fails to capture the time value of the option. Some respondents also argued that in the case of a plan that provides the greater of two benefits, the value of the guarantee should be explicitly taken into account in order to be consistent with IFRS 2 *Share-based Payment* and IAS 39 *Financial Instruments: Recognition and Measurement*. Two typical arguments from comment letters are:

> In principle, stochastic or option pricing techniques would be required to fully understand the value of such a guarantee. (CL 30)

> … our business experience suggests that it is possible to determine the fair value of the liability through stochastic modelling which properly takes into account the operation of the benefit design as a whole, including caps and collars and their interaction. (CL 10)

Fixed/variable distinction

24. A key feature of the D9 measurement approach is the fixed/variable rate distinction. The rationale for this approach was as follows. The defined benefit methodology set out in IAS 19 does not present problems for fixed benefits. However, the discount rate prescribed in IAS 19 seemed inappropriate for variable benefits that depend on future returns on assets (see discussions about the discount rate used below). Thus, it seems intuitively helpful to split out the liability in this way.

25. Respondents said that the distinction between fixed and variable return on assets is not always clear. In addition they said that, where the distinction can be made clear, the proposed measurement method may not always fully capture the nature

of the employer's liability. Consider, for example a plan that provides returns on contributions of 2% plus returns in line with an equity index. The resulting benefit in this case would be a combination of pure fixed returns, pure variable returns and a composite of fixed and variable returns (ie the fixed return on the variable return, and the variable return on the fixed return).

26. Respondents also said that there are plans in which there may not be a natural separation of the two returns into fixed and variable components. For instance, consider a benefit plan based on contributions plus the actual return on assets with a retirement pension at a guaranteed rate below the promised return. This plan works in the following way. Assume the guaranteed annuity value 20 (ie the cost of paying a pension of 1 unit for the rest of the retiree's life is 20). If the value of plan assets at retirement age is 100, the guaranteed pension amount would be 5 per year. If the value of assets at retirement were 160, the guaranteed annual pension amount would be 8. However if the retiree lives for longer than expected or the investment returns post-retirement are worse than expected, the cost to the company of providing a pension of 5 per year would be greater than 100, so the employer has an obligation in respect of these risks.

Appropriateness of a corporate bond yield as the discount rate

27. One of the problems staff identified with the measurement approach is the discount rate that is used. For D9 plans that have only fixed promises there will be some cases in which it would be necessary to project a liability at one rate and discount at a corporate bond yield, which may be inconsistent with the projected rate of return. BC12 of the Basis for Conclusions to D9 suggests that the discount rate (usually a high quality corporate bond rate) may not adequately reflect the risk adjustment required for the asset, and that it would be inappropriate to use that rate.

28. This is however an issue that is not limited to D9 plans as it affects all plans that depend on asset returns. D9 proposed to addresses this in its treatment of the variable promise, but for other plans this remains a problem. This is because the defined benefit methodology in IAS 19 was designed for benefits that do not depend on future returns on assets. For the IAS 19 methodology to work for such

benefits, the discount rate would need to be one appropriate for the benefits, ie one commensurate with their risk. This issue is however beyond the scope an interpretation and would require an amendment to IAS 19.

Other matters

29. Other matters raised by respondents were the following.

Convergence with US GAAP

30. Many respondents asked for convergence with the US to be considered. This was especially relevant in 2005 because the US standard-setter, the Financial Accounting Standards Board (FASB), had at that point a project on its agenda to deal with cash balance plans[3], which in most cases fall within the scope of D9. The FASB stopped work on its project in 2005, because it decided that it would address issues relating to cash balance plans as a part of a broader pension project at a later date. No further work has since been done on the issue by the FASB.

31. Cash balance plans are accounted for as defined benefits plans under US GAAP. There is however a big difference between US GAAP and IFRS, because under US GAAP the traditional unit credit method[4] is applied to these plans, while under IFRSs the projected unit credit method is used.

Scope of the IFRIC's work and due process

32. A few respondents who raised concerns about the scope of the IFRIC's work and said that the draft interpretation was going further than just 'interpreting' the text of IAS 19 and that it was therefore introducing new requirements into the Standard. In addition, concerns were raised about making these changes through an interpretation rather than as an amendment to the Standard because interpretations do not go through such an extensive due process as amendments to Standards.

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[3] Cash balance plans are pension plans in which the pension benefit is determined by reference to amount credited to an employee's account. Those amounts typically comprise in each year a principal amount based on current salary and a specified interest credit. The plans may be funded or unfunded.

[4] The traditional unit credit method does not reflect expected future pay increases in the liability, and only reflects one year's expected growth in pay in the normal cost. The projected unit credit method on the other hand considers expected future pay increases in the calculation of liability and normal cost.

33. Since D9 was issued in 2004 there have been changes both to the mandate of the Committee and to its due process. Especially the changes that have been made recently to the Committee's due process should address most of these concerns.

Application of the 'corridor' method

34. Many respondents commented on that the fact that the draft interpretation did not show how the 'corridor' method should be applied to it. However, the 'corridor' method was removed from the Standard in the 2011 amendments to IAS 19. Accordingly these comments are no longer applicable.

Examples in the draft interpretation

35. There were mainly two aspects of comments on the examples in the draft interpretation. Firstly, respondents asked for examples of plans that included both the fixed and variable components. Secondly, respondents asked for examples that would show how the interpretation would work with the 'corridor' method. As described above, now that the 'corridor' method has been removed from IAS 19, these comments are no longer applicable.

Other issues

36. Respondents raised a few other issues that the Committee may need to consider if it decides to continue work on D9:

(a) the focus on the calculation at the defined benefit liability level rather than at the defined benefit obligation level (which results in the same accounting for example of gains or losses for funded and unfunded plans);

(b) the application of IAS 19.70 (which was previously IAS 19.67)[i] to salary increases;

(c) clarification in respect of some definitions (eg 'promised return'); and

(d) transition requirements, this mostly relates to whether retrospective application should be required.

[i] IAS 19.70 deals with the atribution of benefits to periods of service.