

STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	IAS 19 <i>Employee benefits</i>		
Paper topic	IFRIC Draft Interpretation D9—Scope and measurement		
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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) 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 defined benefit plans when the benefit it provides depends on future returns on assets, with or without an accompanying guarantee of a fixed return.
2. The objective of this paper is to give the IFRS Interpretation Committee (the Committee) an overview of the proposal put forward by staff on scope and asks for direction from the Committee on the revisions needed before exposing a revised draft interpretation. The paper also summarises the work done by staff on measurement in the redeliberations of D9 in 2005. When the issue was referred to the Board in November 2006 the Committee had not taken any decisions on either of those issues although they had been discussed at three meetings in 2005.
3. The staff is therefore asking the Committee how to proceed with the scope of the draft interpretation and for some input on the question of measurement.

Staff analysis

4. After receiving responses to D9 it was clear that there were two main issues that the Committee had to address before it could take the draft interpretation forward. These issues are the scope of the interpretation and measurement of the defined benefit obligation.
5. The following analysis is based on the papers that were presented to the Committee in 2005 when it was redeliberating D9.

Scope

6. As the Committee has decided to revisit D9, it may consider a revision to the scope of the interpretation. The scope of D9 was set to cover plans with a promised return on actual or notional contributions. The Committee had previously reached consensus that the plans that fall within the scope of D9 are defined benefit plans because the employer retains some risk in respect of the guaranteed return.
7. However, some respondents to D9 pointed out that there are a number of plans that provide a promised increase that is not linked to the return on any specific assets, eg where the return is linked to an inflation or equity index or is based on some other measure such as corporate performance. There was in some respondents' opinions some uncertainty concerning whether D9 was also intended to apply to all such plans.
8. Other respondents pointed out that D9 plans exist side by side on a continuum between plans that are clearly defined benefit and those that are defined contribution plans. In their view it was not clear why the scope of the interpretation should be limited to plans that would be defined contribution but for a guaranteed return on actual or notional contributions and excludes other types of guarantees. They considered that it would seem more reasonable to include all of these plans within the scope of the interpretation rather than choose only the ones where the guarantee is directly linked to the return on contributions.

9. Whether the Committee decides to change the scope or not, the number of possible plans that fall within the scope of D9 is considerable. They include plans of one benefit type (eg a plan that promises a return on contributions in line with government bond yields), or a combination of two benefit types (eg a plan which provides the higher of the actual return on contributions and a fixed accrual of 2% of salary per year of service).
10. In addition to this some D9 plans are more complicated still. Some of the so called ‘cash balance’ plans may be defined as the sum of the benefit based on notional contributions plus a specified return and a traditional defined benefit plan, the greater of these or, indeed, something more complex. In other cases, the employer’s obligation may be difficult to estimate because the promised return may be based on corporate performance and is therefore highly variable, or because of guarantees applied at retirement.
11. The Committee could decide to restrict the scope of D9 to plans that provide a promised return on actual or notional assets and exclude those that provide other types of guarantees. However, we are of the opinion that should not be done. Firstly, as explained above, D9 plans exist on a continuum between those that are clearly defined contribution at one end and those that are clearly defined benefit at the other; such plans have both defined contribution and defined benefit elements. Any further subdivision of these plans would likely be based on an arbitrary distinction and lead to greater complexity in the measurement of the employer’s obligation. Additionally, D9 did not require the promised return to be based solely on investible assets¹. For the avoidance of doubt, we suggest that the scope of D9 be amended to clearly include plans that provide other benefit guarantees/promises.
12. Some respondents asked whether the scope includes other long-term benefits. D9 stated that the interpretation applies to defined benefit plans. Under IAS 19 other long-term benefits are treated in the same way as post-retirement benefits and there seems no reason for D9 not to apply to those same benefits

¹ In some cases the return may not be linked to any specific assets, eg where the return is linked to inflation or equity index (with or without a cap) or some other measure like corporate performance.

Staff recommendation

13. The scope of D9 was set to cover employment benefit plans with a promised return on actual or notional contributions. The problem which some respondents to D9 noted with the scope is that it implies a direct connection between the contributions made to the plan and the returns on those contributions (this is however only a problem for funded plans). To cover all plans that provide a guaranteed return on contributions the Committee should clarify that there does not need to be a link between the returns on contributions and the return on the assets held in the benefit plan. Additionally we think that the Committee should clarify that the return on the contributions does not need to be linked to the return on a specific assets.
14. We therefore suggest that a revised D9 should include a slightly revised scope to clarify that an employee benefit plan would fall within the scope of the interpretation if the employer has a legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay for all employee benefits relating to employee service in the current and prior periods in respect of :
 - (a) a promised return on actual or notional contributions; or
 - (b) any other benefit guarantee based on the value of one or more underlying investible or non-investible assets.
15. This would clarify that D9 applies only to defined benefit plans of the specified type. It also clarifies that plans that provide a guarantee not based on the return on the contributions made, but based on the return on, or value of, other assets are included within the scope for completeness. It also confirms that D9 does not require the promised return to be based solely on investible assets, but it can be based on other measures such as corporate performance.
16. We also suggest that a revised D9 should clarify that it includes, not only post-retirement benefits but also other long-term benefits.

Question for the Committee

The staff recommends clarifying the scope of D9 as described in paragraph 13-16, does the Committee agree? If not, how should the scope be defined?

Measurement

17. At its meeting in April 2005 the Committee considered the initial comment letter analysis to D9. The staff paper presenting the comment letter analysis also set out a proposed methodology for measuring the liability that was an amendment of the fixed/variable approach proposed in D9. The Committee rejected that proposal and asked the staff to bring further proposals on measurement to its next meeting. The following is taken from the IFRIC Update for April 2005:

..... The paper also set out a proposed methodology for measuring the liability that was an amendment of the fixed/variable approach proposed in D9 to a deconstruction approach, under which three main components for measurement purposes would be identified: defined benefits, defined contributions and embedded guarantees/options.

The staff proposed this alternative approach to respond to comments that D9, as exposed, would limit development of best practice application of the projected unit credit method. Some respondents had noted that currently, practice is evolving to use valuation methods such as the Black-Scholes method to measure the value of guarantees. Respondents were concerned that the adoption of D9 would preclude methods other than a fixed/variable split. However, the staff noted that current actuarial practice is evolving and may not be using such valuation techniques in a consistent fashion. IFRIC members asked the staff to evaluate a possible amendment to the draft that would include two alternatives:

- use of the fixed / variable approach proposed in D9 or,
- inclusion of any embedded guarantees or options within the measurement of the defined benefit obligation as a whole.

IFRIC members rejected a proposal to split a defined benefit plan into a component accounted for as a defined contribution plan and a component accounted for as a defined benefit plan. They believed that this was not consistent with IAS 19.

18. The staff brought papers on measurement to the Committees at its meetings in June and August 2005. In those papers the staff explored four possible measurement approaches which are listed below. A more detailed description of the approaches is included in the Appendix to this paper.

Measurement approaches explored by staff in 2005

19. This section of the paper describes at a high level the four approaches to the measurement of D9 plans which the staff presented to the Committee in 2005. A brief summary of the approaches is set out below. More detailed explanations are provided in the Appendix to this paper.

Fixed/Variable approach

20. The fixed/variable approach splits the D9 plan into fixed and variable components. The balance sheet liability is equal to the higher of the fixed or variable components and is calculated net of assets and unrecognised balance sheet items. The components of the defined benefit pension costs are based on the fixed component only and the change in the variable component is included as an additional single expense item.

Modified fixed/variable approach

21. The modified fixed/variable approach also splits the plan into fixed and variable components. However, the calculation of the gross defined benefit obligation is required and the components of the defined benefit pension cost

represent the changes in both the fixed and variable components, thus making this approach more consistent with the standard.

Pure deconstruction approach

22. The pure deconstruction approach splits the plan into defined benefit, defined contribution and embedded guarantee components. The derivation of the components of the defined benefit pension cost is required to be consistent with the nature of the entity's risk in respect of each component.
23. This approach was rejected by the Committee in April 2005 as it was deemed inconsistent with the measurement requirement of IAS 19 as IAS 19 does not allow the use of different approaches for different components of the entity's obligation. The staff did however, include this approach in the August 2005 for completeness and also included as an appendix in that paper suggested changes that would have to be made to IAS 19 for this approach to work.

Modified deconstruction approach

24. The modified deconstruction approach also splits the plan into defined benefit, defined contribution and embedded guarantee components. However, the components of the defined benefit pension costs are calculated in a manner consistent with IAS 19.

Staff analysis

25. Staff is currently analysing the work done on measurement in 2005 with the view of bringing a proposal on measurement to the Committee at its next meeting. In addition to that staff is conducting further outreach on issues relating to measurement of D9 plans.
26. The outreach which the staff has already undertaken recently suggest that some preparers are using the fixed/variable measurement approach in D9. However, the staff does not at this point have sufficient information on how widespread that use is and whether those applying D9 have simple or more complex plan structures. The staff therefore needs to do further outreach on measurement for plans that would be included in the scope of D9 before it

can make a recommendation on the issue to the Committee. The staff would however welcome the Committees views on this issue.

Question for the Committee

Does the Committee have any comments or direction for the staff on the measurement approach for D9?

Appendix – Extract from Agenda Paper 4 from the August 2005 Interpretations Committee Meeting

The four measurement approaches as presented in paper 4 for the August 2005 Committee meeting

Fixed/Variable (as per D9)

A1. The fixed/variable approach set out in D9 split the entity's liability in respect of a D9 plan into fixed and variable components. The rationale for this approach was that while the defined benefit methodology set out in IAS 19 does not present problems for fixed benefits, the use of the discount rate prescribed in IAS 19 seemed clearly inappropriate for variable benefits that depend on future returns on assets. Thus, it seemed intuitively correct to split out the liabilities in this way.

A2. The fixed component was the portion of the liability with a guarantee of a fixed return. Otherwise, the liability is variable.

Example 1:

A lump sum equal to the higher of the actual return on plan assets and an annual return on contributions of 4% per year.

A3. For a plan such as the one in example 1, the defined benefit liability is the higher of the two values. In essence, therefore, the fixed/variable approach measures the intrinsic value of any embedded guarantees rather than the fair value (ie the difference between the value of assets and the present value of the fixed component with no allowance for time or volatility, rather than the fair value of the embedded guarantee using Black-Scholes or an appropriate financial economics approach).

A4. The fixed component liability is calculated in accordance with IAS 19, using the projected unit credit method. The variable component liability is equal to the value of the plan assets at the balance sheet date. For some plans, this approach would be the same as measuring the defined benefit component plus the intrinsic value of the embedded guarantee element of the benefit promise.

A5. The service cost, interest cost and actuarial gains and losses are calculated in respect of the fixed component only. Any change in the variable component due

to employee service, interest cost or actuarial gains and losses are included as a single expense item.

- A6. If the present value of the fixed component liability is lower than the plan assets at the balance sheet date, an additional variable liability equal to the difference is recognised. If, during the year, the value of assets fall below the present value of the defined benefit obligation, the additional variable liability is adjusted. The fixed/variable approach does not require the calculation of the defined benefit obligation, ie there is no calculation of the gross liability before the allowances for assets and any as yet unrecognised balance sheet items. The reason for this is that it was difficult to determine how to disaggregate the change in the variable component into service cost, interest cost and actuarial gains and losses in some cases and particularly where there is a change during the year from the fixed component being higher to the variable component being higher. Therefore, the entire change in the variable component is recognised as a single expense item and the balance sheet liability is calculated on a net basis ie only the net defined benefit liability which takes into account the value of assets and unrecognised items is calculated.

Modified Fixed/Variable

- A7. The modified fixed/variable approach amends the fixed/variable approach so as to make it more consistent with IAS 19, while retaining the split into fixed and variable components.
- A8. In particular, under this approach, the calculation is performed at the defined benefit obligation level as required under IAS 19 and the service cost and interest cost components of the variable component are approximated. Also this approach requires the present value of the variable component to be measured with reference to the fair value of replicating assets².
- A9. The service cost for the variable component is determined as the amount by which the defined benefit obligation has increased as a result of employee service. For instance, for the plan in example 1, it is approximated to be equal to the

² This was not made explicit in the draft interpretation and some commentators were unclear on the application of the fixed/variable approach for an unfunded plan, for instance.

proportionate share of the annual actual or notional contributions paid. The interest cost is determined in the same way as for the fixed component and the actuarial gain or loss is the difference between the expected value of the variable component given this disaggregation and the actual value at the end of the year.

- A10. Under the fixed/variable approach under D9, the net defined benefit liability at the end of the year will either be equal to the value of assets or equal to the fixed component liability depending on which is higher. However, under the modified fixed/variable approach, the change in the defined benefit obligation and the value of assets is tracked separately and the resulting net defined benefit liability is a more accurate calculation.
- A11. One difficulty with the modified fixed/variable approach is that the nature of the defined benefit liability may change a number of times during the year depending on the movement in the value of assets. Strictly the service cost and interest cost should track these changes in the defined benefit liability in order to be consistent with the principle of the measurement of the liability representing the nature of the risk to which the entity is exposed. However, this would be extremely difficult and complicated to do. As a proxy, where there is a change during the year from the fixed benefit being higher to the variable benefit being higher, an approximate date for the switch over period is determined and the service cost and interest cost are determined accordingly. Alternatively, the service cost could be based simply on the position at the beginning or end of the year. This could give rise to anomalous results however.
- A12. In any event, as explained below, the fixed/variable approaches are significantly flawed in that they do not allow for more complex benefit structures and do not give a faithful representation of the entity's obligation.

Pure deconstruction approach

- A13. The pure deconstruction approach is based on the fact that whilst all D9 plans are defined benefit (because the entity is on risk for a part of or all of the benefit promise), the nature of the risk to which the entity is exposed for the different components will be different. In particular, a D9 plan is composed of defined benefit, defined contribution and embedded guarantee components. Therefore the

valuation approach to be applied to each component should be different in order to accurately represent the nature of the entity's obligation in respect of these risks.

- A14. In particular, for plans that have any combination of defined benefit, defined contribution and embedded guarantee elements, any approach that is fully consistent with IAS 19 would lead to anomalous results in some cases³.
- A15. As mentioned previously, it would seem appropriate to use the approaches that reflect the nature of the entity's risk in respect of each component. However, the use of different approaches for different components of the entity's obligation is not currently permitted under IAS 19. Therefore an approach that would be faithful to the nature of the entity's risk in respect of the benefit promise would require an amendment to the standard.
- A16. For example, there are plans where the entity has no risk in respect of a significant portion of the benefit promise. For instance, consider the following benefit promise:

Example 2:

A pension equal to the actual return on assets converted at a guaranteed annuity rate of 10%.

This plan works in the following way. Assume the guaranteed annuity rate of 10% (i.e. the cost of paying a pension of 1 unit for the rest of the retiree's life is 10). If the value of plan assets at retirement age is 100, the guaranteed pension amount would be 10 per year. If the value of assets at retirement were 160, the guaranteed annual pension amount would be 16.

Therefore, 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 10 per year would be greater than 100, so the employer has an obligation in respect of these risks.

However, regardless of the change in the value of assets, the entity has no upside or downside risk in respect of the movement in the value of assets pre-retirement.

- A17. The entity retains the risk that the cost of the pension benefit payable at retirement may cost more than 10 per unit, so that the accumulated assets at retirement may be insufficient to provide the guaranteed benefit. However, the entity has no risk

³ There is not a single valuation method that would be appropriate for each of the components of a D9 plan. For instance, the traditional application of the projected unit credit method cannot be applied to embedded guarantees. Also, there is an inherent inconsistency in the approaches used for measuring the defined benefit obligation for defined benefit and defined contribution plans under IAS 19.

in respect of the accumulation of assets provided that contributions are paid and invested in accordance with the plan rules.

- A18. The pure deconstruction approach models the fact that D9 plans may contain defined benefit, defined contribution and embedded guarantee components and aims to value the entity's defined benefit obligation and the pension cost elements in respect of each component consistently with the nature of the risk to which the entity is exposed. In particular, in this case, the pre-retirement liability is the defined contribution component and the post-retirement guarantee is the embedded guarantee.
- A19. In general, the defined benefit component is the benefit promise that cannot be replicated (eg because it is salary related or because it is a fixed benefit not provided on the market, or because the available market is not sufficiently deep or liquid). This is valued using the traditional application of the projected unit method (ie the project and discount approach). The defined contribution component is the part of the benefit promise that could be replicated using the actual matching assets available in a deep and liquid market and the entity's obligation is equal to the value of those replicating assets. The embedded guarantee component is the part of the benefit promise that is linked to two or more underlying investible or non-investible assets and is valued using a fair value approach⁴.
- A20. The deconstruction approach does not require an arbitrary deconstruction of a benefit promise into small elements that would not normally be separated. For instance, a final salary plan would not be split into a current salary plan plus an additional salary-related benefit.
- A21. Where there is any doubt as to how the benefit should be deconstructed, the following hierarchy should be observed:
- The embedded guarantee component
 - The defined benefit component
 - The defined contribution component

⁴ The fair value approach is a sophisticated modelling approach used in financial economics and is similar to the valuation approaches used in IFRS2 and IAS 39.

- A22. The staff considers that it is important for the entity to recognise the nature of embedded guarantees in the benefit promise and the ranking of this component first reflects its importance.
- A23. The defined benefit component ranks above the defined contribution component because of the inconsistency within IAS 19 in the measurement of the liabilities for defined benefit and defined contribution plans. There are some plans that could be deconstructed into either a defined contribution component and embedded guarantee component or a defined contribution component and an embedded guarantee component. Under IAS 19, the different approaches would give different results. Therefore in order to promote consistency and in accordance with the classification of the plan as defined benefit, the defined benefit nature of the plan should rank above the defined contribution nature of the plan.
- A24. Under the pure deconstruction approach, the defined benefit obligation is split into components that are valued separately and aggregated to determine the gross defined benefit obligation. This is in contrast with the fixed/variable approaches where one or the other of the components takes precedence at different points in time. In addition, the pure deconstruction approach allows for more complicated benefit structures, a more accurate subdivision of the components of the entity's liability and a result that is a more faithful representation of the entity's obligation than the fixed/variable approaches. The present value of the defined benefit obligation is measured by summing the entity's obligation in respect of each component into which the obligation has been subdivided.
- A25. The components of the pension cost are determined as follows: For the defined benefit and defined contribution components, these are determined in strict compliance with the IAS 19 requirements for defined benefit plans and defined contribution plans.
- A26. For the embedded guarantee component, the concept of an interest cost could only be applied in an artificial way. Further, an identification of the interest cost for the embedded guarantee would be of dubious value to users of the accounts. Therefore the change in the value of the embedded value is split into service cost and actuarial gain/loss items only.

- A27. The service cost is equal to the difference between the expected value of the embedded guarantee at the end of the year and the actual value of the embedded guarantee at the beginning of the year. The expected value would be based on the expected assumptions for: volatility, price of the underlying asset, the strike price and any other key assumptions pertinent to the method being used.
- A28. The actuarial gain/loss is determined by evaluating the difference in the value of the embedded guarantee at the end of the year using the expected assumptions at the balance sheet date with the value using the actual assumptions at the balance sheet date.
- A29. In other words, the effect of expected volatility as well as expected changes in the term, price of the underlying asset and the strike price are considered to be equivalent to the increase in the entity's obligation as a result of the employee rendering more service and are included in the service cost. The difference between the expected and actual volatility assumptions, price of the underlying asset and the strike price as well as the effect of a change in the risk free interest rate are treated as an actuarial gain or loss.

Modified deconstruction approach

- A30. The pure deconstruction approach is not fully consistent with IAS 19 because the components of the pension costs are not determined in strict accordance with IAS 19 requirements. For instance, IAS 19 requires the interest cost to be determined as the interest rate multiplied by the present value of the defined benefit obligation at the beginning of the year. This approach would lead to inconsistent results where there is a defined contribution element (the true interest cost in these plans is effectively the expected rate of return on assets, not the IAS 19 discount rate, multiplied by the defined benefit obligation at the beginning of the year). It would also lead to inconsistent results where there is an embedded guarantee, as the concept of an interest cost does not strictly apply here.
- A31. The present value of the defined benefit obligation is calculated in the same way under the modified deconstruction approach as for the pure deconstruction approach. However, in order to be consistent with IAS 19, the modified

deconstruction approach adjusts the determination of the components of the pension expense as follows:

- A32. The interest cost is determined as the IAS 19 discount rate multiplied by the present value of the defined benefit obligation at the beginning of the year for each component.
- A33. The service cost for the defined benefit component is determined in accordance with IAS 19. The service cost for the defined contribution component, is equal to the amount of contributions or notional contributions payable. The service cost for the embedded guarantee is the same as for the pure deconstruction approach except for the allowance for a change in the term to maturity.
- A34. As for the pure deconstruction approach, the actuarial gain or loss is determined as a residual difference between the actual and expected values for each component.
- A35. The modified deconstruction approach is therefore the same as the pure deconstruction approach but for the derivation of the components of the pension cost for the defined contribution and embedded guarantee components.