# STAFF PAPER

**15–16 May 2012**

## IFRS Interpretations Committee Meeting

| Project | IAS 19 Employee benefits | | |
|---|---|---|---|
| Paper topic | Chapter 7 of the Discussion paper *Preliminary views on Amendments to IAS 19 Employee Benefits* | | |
| CONTACT(S) | Jon Baldurs | jbaldurs@ifrs.org | +44 (0)20 7246 6467 |

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*.

# Discussion Paper

# Preliminary Views on Amendments to IAS 19 *Employee Benefits*

This discussion paper *Preliminary Views on Amendments to IAS 19* Employee Benefits is published by the International Accounting Standards Board (IASB) for comment only. Comments on the contents of the discussion paper should be submitted in writing so as to be received by **26 September 2008**. Respondents are asked to send their comments electronically to the IASB Website (www.iasb.org), using the 'Open to Comment' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

The IASB, the International Accounting Standards Committee Foundation (IASCF), the authors and the publishers do not accept responsibility for loss caused to any person who acts or refrains from acting in reliance on the material in this publication, whether such loss is caused by negligence or otherwise.



ISBN: 978-1-905590-62-9



**Additional copies of this publication may be obtained from: IASC Foundation Publications Department,**
**1st Floor, 30 Cannon Street, London EC4M 6XH, United Kingdom.**
**Tel: +44 (0)20 7332 2730**
**Fax: +44 (0)20 7332 2749**
**Email: publications@iasb.org**
**Web: www.iasb.org**

# Chapter 7 Measurement of contribution-based promises – core issues

7.1 This chapter discusses the characteristics that the Board seeks in the measurement of contribution-based promises. The Board considered the following:

- identifying the unit of account.
- selecting a measurement attribute.
- implications for plans that IAS 19 currently classifies as defined contribution plans.

7.2 In the Board's preliminary view, an entity should measure its liability for a contribution-based promise at fair value assuming the terms of the benefit promise do not change. This chapter describes the rationale for this preliminary view.

## Identifying the unit of account

7.3 A contribution-based promise can be divided into two components:

- a contribution amount
- a promised return (if any).

7.4 The Board considered whether entities should measure separately the two components of a contribution-based promise. Some think that the contribution component in a contribution-based promise is similar to a defined contribution plan in IAS 19. Accordingly, the Board considered whether the contribution amount should be measured in the same way as a defined contribution plan is measured in IAS 19. In that case, the Board would only need to consider a measurement attribute for the promised return, which does not exist in defined contribution plans in IAS 19.

7.5 However, any approach that measured the liability for the contribution amount differently from the promised return could lead to the same economic obligation being accounted for differently. For example, assuming the benefits vest in five years, the following promises are economically identical:

- a promised lump sum of CU1,340 paid in five years (ie a contribution of CU1,340 plus a fixed return of 0 per cent); and
- a promised lump sum of CU1,000 plus a fixed return of 6 per cent per year paid in five years.

7.6 Applying different measurement bases to the contribution amount and the promised return would result in a different measurement of the liability, depending on how it is described. This provides opportunity for accounting arbitrage. Accordingly, the Board concluded that there should be a single measurement basis for the contribution amount and the promised return. In other words, the unit of account is the entire contribution-based promise.

## Selecting a measurement attribute

7.7 The Board's objective is to select a measurement attribute for a contribution-based promise that gives users of financial statements useful information about the amount, timing and uncertainty of future cash flows resulting from that promise. The Board thinks that a measurement approach that includes the following characteristics would meet that objective:

- an estimate of the future cash flows
- the effect of the time value of money
- the effect of risk.

7.8 Measurement attributes exhibit these characteristics in different ways. For example, cash flow estimates may be current or historical, discounting may be incorporated explicitly, and an explicit or implicit allowance for risk may be included. Paragraphs 7.9–7.35 consider how, and to what extent, each characteristic should be included in the measurement of a contribution-based promise. Paragraphs 7.36–7.40 draw together the Board's preliminary views on how each characteristic might be incorporated to achieve a useful measurement attribute for contribution-based promises.

## Estimate of cash flows

### *Overall objective for estimates of cash flows*

7.9 Paragraph 7.7 identifies the characteristics that the Board thinks should be incorporated in the measurement of a post-employment benefit liability. The first characteristic is an estimate of the future cash flows arising from the benefit obligation. As with IAS 19, the Board intends to give high level guidance on the estimation of such cash flows, but not detailed guidance, such as might be found in an actuarial textbook. In summary, the Board's preliminary view is that in measuring benefit liabilities, an entity should make estimates of future cash flows that:

(a) are explicit;

(b) are as consistent as possible with observable market factors;

(c) incorporate, in an unbiased way, all available information about the amount, timing and uncertainty of all cash flows arising from the obligation; and

(d) are current, in other words they correspond to conditions existing at the end of the reporting period.

### *Explicit estimates*

7.10 Some think that estimates of cash flows should be explicit in all cases. IAS 19 requires explicit assumptions to be made of the variables underlying the cost of defined benefit promises. Others think that explicit estimates are not needed if the overall measurement of the liability is such that it is unlikely that the actual cash flows will exceed that measurement. However, in the Board's preliminary view, explicit estimates result in a more faithful representation of the claims of employees on the resources of the entity. The resulting information is more relevant to users, more understandable and more comparable with information produced by applying IFRSs to other liabilities, in particular non-financial liabilities (IAS 37).

### *Consistency with observed market prices*

7.11 Some inputs used to estimate cash flows relate to observable market variables. For example, when a contribution-based promise includes a return that depends on the performance of an equity index, the value of that index reflects market expectations of future cash flows. Some think that an entity should substitute its own estimate of those variables if the entity thinks other evidence is more persuasive than the observed rates or prices. Some also think that short-term fluctuations in market prices are of limited relevance for long-duration contracts that entities generally do not (and cannot) transfer to a third party.

7.12 However, the Board's preliminary view is that measurements are more relevant and reliable if they are consistent with observed market factors, because such measurements:

- involve less subjectivity than measurements that use the entity's own estimates.
- reflect all evidence available to market participants.
- are developed using a common and publicly accessible benchmark that users can understand more easily than information developed using a private internal benchmark.

7.13 Therefore, the Board's preliminary view is that the inputs used to develop estimates of cash flows should, as far as possible, be consistent with observed market factors. In other words, an entity would use observable current market variables, such as the value of an equity index, as direct inputs without adjustment.

### *Unbiased use of all available information*

7.14 The cash flows associated with a contribution-based promise are uncertain. In other words, more than one outcome is possible. Some think that a measurement of a benefit liability should use a single estimate of the cash flows, such as the most likely outcome. This is the approach in IAS 19 for defined benefit promises.

7.15 However, a measurement of a contribution-based promise liability is most useful if it captures information about the full range of possible outcomes and their probabilities because it provides more information about the possible variability in cash flows.

7.16 In the Board's preliminary view, the measurement of a contribution-based promise liability should be based on an expected value approach. The expected present value is the probability-weighted average of the present value of the cash flows. This approach considers all possible outcomes.

 

7.17 Estimates of the probabilities associated with each cash flow scenario should be neutral. In other words, they should not be biased with the intention of attaining a predetermined result or inducing particular behaviour. Neutrality is essential because biased financial reporting information cannot faithfully represent economic phenomena. Among other things, neutrality requires estimates of cash flows and the associated probabilities to be neither conservative nor optimistic.

### *Current estimates*

7.18 IAS 19 requires the measurement of defined benefit liabilities to be based on current estimates of cash flows. The Board's view is that entities should use current estimates for the measurement of contribution-based promises for the following reasons:

- They give a more faithful representation of the entity's obligations and convey more useful information about the amounts, timing and uncertainty of the cash flows generated by those obligations and rights. Given the uncertainty associated with a promised return, and the long duration of many contribution-based promise liabilities, current information about the amount, timing and uncertainty of cash flows is relevant for users.
- They require an entity to consider whether circumstances have changed.
- The measurement incorporates all available information.
- Their use is consistent with other IFRSs for non-financial liabilities (IAS 37) and some financial liabilities (IAS 39). Both IAS 37 and IAS 39 require measurements based on current estimates of future cash flows.
- Their use reduces possible accounting mismatches between contribution-based liabilities and plan assets, and should highlight economic mismatches.

## Time value of money

7.19 IAS 19 requires discounting for defined benefit liabilities and defined contribution liabilities that are due more than twelve months after the reporting date. The Board's preliminary view is that the time value of money should also be included in the measurement of contribution-based promises. As with the estimates of cash flows, a current measure of the time value of money should be used.

## The effect of risk

7.20 The objective of including the effect of risk in the measurement of a contribution-based promise liability is to convey decision-useful information to users about the uncertainty associated with future cash flows.

7.21 For post-employment benefit promises, the effect of risk on the liability cannot be observed because typical benefit arrangements have no initial transaction price with which to calibrate the cash flow estimates. However, an adjustment for the effect of risk is needed because there would otherwise be no difference between a liability with fixed future cash flows and one with uncertain future cash flows with the same expected return. Some hold the view that no risk adjustment is needed for factors that are uncorrelated with changes in the value of market assets (diversifiable risk). The Board has not yet discussed this view or its implications for the measurement of contribution-based promises.

7.22 The Board noted that contribution-based promises do not expose the employer to some of the risks that are common in typical defined benefit promises. For example, a contribution-based promise does not expose the entity to salary risk (because the benefit for current and prior periods is not affected by future increases in salary). The Board identified the main risks in a liability resulting from a contribution-based promise as:

- asset-based risk, ie the risk that the liability for benefits promised will fluctuate because of changes in the value of the assets or indices. Asset-based risk is similar to market risk for financial instruments.[*]
- demographic risk, in particular longevity risk. However, for many contribution-based promises, the benefit at retirement is a lump sum, or an annuity set at market rates. In these cases, longevity risk would not be significant during the accumulation phase.
- credit risk, ie the risk that the entity would be unable to make the necessary payments.
- risk that the terms of the benefit promise change.

[*] Market risk is defined as 'The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices.'

### *Asset-based risk*

7.23 Inclusion of an appropriate measure of the effect of asset-based risk is one of the main improvements that the Board wishes to make to the measurement of contribution-based promises. The Board thinks that often the effect of asset based risk can be determined by reference to observable market prices of similar assets.

7.24 Accordingly, the Board's preliminary view is that the effect of asset-based risk should be included in the measurement of a contribution-based promise liability.

### *Demographic risk*

7.25 As noted in paragraph 7.22 the Board thought that demographic risks would be less significant than asset-based risks for many contribution-based promises. Nevertheless, the Board's preliminary view is that, when such risk is present, its effect is relevant information that should be included in the measurement of contribution-based promises.

### *Credit risk*

7.26 The Board considered whether to reflect credit risk in the measurement of a contribution-based promise. Credit risk is, generally, the risk that one party to a financial instrument will cause a financial loss for the other party. More specifically, for a contribution-based promise, it is the risk that the assets available to meet the benefit promise, including both plan assets, if any, and the entity's assets, would be insufficient, thus causing the entity to be unable to make the necessary payments. Credit risk could have a significant effect on the measurement of entities' liabilities for benefits for past service.

7.27 In principle, the Board thinks that the effect of the credit risk of a liability is relevant information that should be included in its measurement.

7.28 However, the Board notes that including the credit risk specific to the contribution-based promise would be a significant change and could be difficult to do for the following reasons:

- The initial exchange of services for post-employment does not provide a readily observable price for the risk.
- The credit risk of the contribution-based promise may be affected by other liability-specific matters, such as any funding of the promise. Contribution-based promises are unlikely to have specific issue credit ratings and the necessary adjustments to an entity credit rating may be difficult to establish.

7.29 The Board noted that these issues also apply to the measurement of some other liabilities for which the entity is required to take credit risk into account. Therefore, the Board did not think that the issues raised in paragraph 7.28 are a sufficient justification for excluding credit risk from the measure of the liability for contribution-based promises. However, the Board is interested in hearing views on how any practical issues might be resolved.

### *Risk that the terms of the benefit promise change*

7.30 The Board considered whether to reflect, in the measurement of the liability for a contribution-based promise, the risk that the terms of the benefit promise change.

7.31 The terms of the benefit promise may change for a number of different reasons. For instance, there may be a statutory change or a change in industry practice.

7.32 The Board noted arguments that the measure of the liability should take into account all possible future events, including the possibility that the entity decides to change the terms of the benefit promise. However, the Board's view was that to do so would misrepresent the nature of the entity's obligation. The Board thought that the unit of account should be the benefit promise that has been made, not a benefit promise that might exist in the future. The measurement of that item should include the possibility that the entity may be unable to make the payments necessary but should not include changes to the item itself. The former is the credit risk for the liability for the benefit promise, the latter is not.

7.33 Therefore, the Board concluded that contribution-based promises should be measured on the basis of the assumption that the terms of the benefit promise will not change.

 

### Summary of the Board's preliminary view on the measurement of contribution-based promises

7.34 The Board's preliminary view is that the measurement of an entity's liability for a contribution-based promise should incorporate the following characteristics:

- explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows.
- current market discount rates that adjust the estimated future cash flows for the time value of money.
- the effect of risk, other than the risk that the terms of the benefit promise change.

7.35 In the Board's view, a measurement that includes those characteristics provides several benefits to users of an entity's financial statements:

- It includes relevant information about the amount, timing and uncertainty of future cash flows arising from a promised return. Given the uncertainty associated with post-employment benefit promises and the long duration of many promises, such information is important.
- It provides consistency with other IFRSs that require current estimates of future cash flows in measuring non-financial liabilities (see IAS 37) and financial liabilities (see IAS 39).
- There is no need to separate embedded options and guarantees because the measurement includes a market-consistent estimate of both their intrinsic value and their time value. If features of the embedded options or guarantees are interdependent, separating them may be arbitrary and costly.
- It is consistent with observable current market prices, to the extent they are available. Such prices provide a more understandable and credible benchmark for users, even though market prices are not available to support all inputs used in measuring contribution-based liabilities.

## Identifying the measurement attribute

7.36 A measurement attribute that exhibits the characteristics in paragraph 7.34 will be most helpful to users if it represents faithfully a real-world economic attribute of the liability being measured. Assets and liabilities have various attributes, such as cost, depreciated cost, amortised cost or various forms of current value, such as fair value. The attribute used in the financial statements is sometimes described as the measurement attribute.

7.37 The Board did not consider cost-based attributes for the measurement of contribution-based promises. Cost-based attributes cannot be readily observed for transactions between entities and employees because the cost of providing the benefit to employees for a period is the service provided by employees during that period. In addition, cost-based attributes do not use current estimates of all the information available.

7.38 The Board noted that a contribution-based promise is similar to a contract that includes a derivative because there is a wide variability in the future cash flows required to settle the liability. IAS 39 requires derivatives to be measured at fair value. The Board noted that fair value is a measurement attribute that incorporates the characteristics that the Board seeks for measurement and represents faithfully an attribute of a contribution-based promise liability. It is a measurement attribute with which users of IFRSs are familiar and is defined as 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction'.

7.39 The Board concluded that a clear and concise way of expressing the Board's desired measurement is *fair value assuming the terms of the benefit promise do not change*. The application of this measurement attribute is illustrated in the examples below.

**Example 1**

An employer promises to pay at retirement a contribution of CU1,000 and a market total equity return per year on that contribution until the employee retires. The benefit vests on the first day of service. The fair value of that promise, assuming the terms of the benefit promise do not change, would include the effect of credit risk and may, therefore, be less than CU1,000.

**Example 2**

An employer promises to pay at retirement a contribution of CU1,000 and a fixed return of 4 per cent per year until the employee retires. The contribution vests on the first day of service. The fair value of the promise, assuming the terms of the benefit promise do not change, is CU1,000 plus the compound effect of 4 per cent

per year discounted at a rate that reflects the credit risk specific to the promise.

7.40 The Board acknowledges that *fair value assuming the terms of the benefit promise do not change* may not be fair value. This is a question that will be addressed in the fair value measurement.

## Implications for plans that IAS 19 classifies as defined contribution plans

7.41 The Board does not intend to change significantly the accounting for most post-employment benefit plans that IAS 19 classifies as defined contribution plans. IAS 19 requires the liability for a defined contribution plan to be measured as unpaid contributions, discounted using a high quality corporate bond rate if they are not wholly due within twelve months after the end of the period in which the employees render service.*

7.42 A promise that is classified as a defined contribution plan in IAS 19 is a contribution-based promise. The proposal that the contribution amount should be measured at fair value assuming the terms of the benefit promise do not change would cause a change in accounting because any unpaid contributions could be discounted at a rate different from a high quality bond rate.

7.43 However, if a promise is classified as defined contribution in IAS 19 and the entity pays the contributions soon after the period to which they relate, the effect of the change in measurement is likely to be insignificant. The Board thinks that this will be the case for many promises that are classified as defined contribution in IAS 19.

* Paragraph 45 of IAS 19 requires that 'Where contributions to a defined contribution plan do not fall due wholly within twelve months after the end of the period in which the employees render the related service, they shall be discounted using the discount rate [for a high quality corporate bond].'

 