# STAFF PAPER

18–19 September 2012

## IFRS Interpretations Committee Meeting

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| **Project** | **IAS 19 *Employee Benefits*** | | |
| Paper topic | IFRIC Draft Interpretation D9–Outreach summary | | |
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## Introduction

1. The objective of this paper is to inform the IFRS Interpretations Committee (the Committee) about the outreach that we have undertaken to gather information about the types of plans it should consider in its work when reconsidering the work done on draft interpretation D9 *Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions*.

2. This paper does not have any questions for the Committee but provides information which should be considered when decisions about scope of the project and the measurement approach used in the project will be made.

3. In June 2012 we sent out a request for information about the types of contribution-based promises in use, and on the use of such promises, to national standard-setters, securities regulators and members of the employee benefits working group. This request was built on information we had gathered in May 2012 when we requested information from national standard-setters and regulators about the use of contribution-based promises.

4. The objective of the outreach was to make sure that we were aware of the most common types of employee benefit plans that could be classified as contribution-based promises, that we were accurately describing their features and to gather information about how these plans are accounted for.

5. We received 21 responses to our request, of which 12 were from national standard-setters, 4 from securities regulators, 4 from members of the employee benefits working group and one from a professional organisation of actuaries.

6. The responses confirmed that the descriptions of plans and their features, which are included in the appendix to this paper, cover the plans that the Committee should consider including in its work. There may however be plans which have specific features that might not be captured by the description in the appendix, but these would be rare in the respondents' opinions. The responses also indicate that the mapping we have done of the use of these plans in the appendix is reasonably accurate.

7. Many respondents are however uncomfortable with the use of the term 'contribution-based promises' and think that a different term should be used.

8. Finally there seems to be general support for addressing the accounting for these kinds of plans, especially because there is divergence in how they are accounted for.

9. The overall conclusion which staff draws from the outreach is that there are many different approaches used to account for the employee benefit plans which could fall under the work the Committee is taking on. There does not seem to be one approach which is predominantly used on an international basis. It is also clear from the outreach that respondents think that this is a troublesome area of accounting as IAS 19 does not provide a suitable guidance on how to account for these kinds of plans which leads to diversity in practice.

## Types of plans that should be addressed

10. In question 1 in our request for information we asked if the Committee should consider in its work on 'contribution-based promise' plans any plans other than those described in the table in the appendix to this paper. If there were such plans, we asked how they differed from the plans described in the appendix and why should they be addressed.

11. The responses indicated that the description we provided covered most of these plans. There may however be other features that have evolved in practice, but we were not given any examples of such features.

12. There does however seem to be some uncertainty about whether certain types of plans should fall within the scope of the work that the Committee is undertaking. For example, plans with a guaranteed return on the contributions made when the employer contracts parts or all of the investment risk out to an insurance company. The problem we have been told about here is that the employer is ultimately responsible for the guaranteed return if the insurance company were to become insolvent. In addition, depending on the mechanism used for adjusting the insurance company's premium over time, the employer may still bear some risks associated with the returns guaranteed by the insurance company. Another concern with insured plans that was raised by respondents is 'profit insurance contracts' where the insurer gives the policyholder a share in the profits arising from the contract. In these instances there may be some issue about:

    (a) whether the employer's contribution changes if experience on the contract is bad; or

    (b) whether the employer benefits changes if the experience on the contract is good.

13. Some respondents also raised concerns over the use of the term 'contribution-based promises'. This term was used by the IASB in its 2008 Discussion Paper, *Preliminary Views on Amendments to IAS 19 Employee Benefits,* in a different context and there covered a much wider range of plans, such as plans that under current IAS 19 would be classified as defined contribution plans. The respondents therefore urge the Committee to use other terms. They suggest using the term originally used by the Committee in its work on D9, that is 'plans with a promised return on contributions or notional contributions' or 'hybrid plans'. Staff is of the opinion that the original term used by the Committee in its work on D9 should be used.

14. There was also a suggestion by one respondent to change the definition of a defined contribution plan so that 'cash balance plans' would meet that definition.

It was also suggested that a distinction should be made between benefits paid as a lump sum and benefits paid as an annuity.

15. Finally, some respondents raise concern about the scope of the Committee's work. There are many types of plans that have similar features, but because of the structure of the plans would perhaps be given different accounting treatment if they were considered to fall within the scope of the Committee's work. On this issue one respondent says the following:

> The choice of how to describe a plan to best communicate (or sell the concept) to employees should not result in different accounting for economically identical plans. This issue--the fact that plans tend to fall across a spectrum of designs with few bright line distinctions--was recognized by IASB staff in an excellent paper they presented at the early stages of the project. This is a fundamental reason why addressing "contribution-based promises" was dropped from the project—isolating individual plan design and providing guidance on those designs leads to conflicts and inconsistencies between plans. As such, defining measurement approaches generally has to take all types of plans into account, not just a segment from the continuum.

## Description of the plans

16. Respondents generally agreed that the descriptions we provided of the plans were accurate and reflected the differences between them.

17. There were however some points raised on this issue. For example, that it might be appropriate to distinguish between plans with a guaranteed return where:

(a) the return credited is simply the actual return on assets, subject to a guarantee level; and

(b) the return credited depends on the overall financial position of the plan. The plan depends on the assets' return, but also on other factors influencing the funded status of the defined benefit obligation (eg longevity and experience) and other influences on funding level (eg contributions).

18. Another respondent pointed out that the timing and frequency of when the return guarantee is effective is another important factor to focus on in the assessment of a plan. The timing and frequency of the return guarantee matters because it creates a different level of obligation for the employer. For example:

    (a) a return guarantee to be met and measured each year (eg 3 per cent each year); or

    (b) a return guarantee to be measured and checked at some points in time (usually at retirement date or when the employee leaves the company).

## Countries in which the plans are used

19. From the information we had before conducting this outreach plans with a guaranteed return on contributions were common in Germany, the Netherlands, Belgium, Switzerland, Israel and could be found in Korea and Mexico. We also had information that 'cash balance plans' were common in the US, Japan and the UK.

20. The responses mostly confirmed our understanding of where these kinds of plans are used. However, some points were made on the use of these plans.

21. Cash balance plans do not seem to be widely used in the UK, but plans with similar features seem to be common in Australia and Canada in addition to the US and Japan.

22. It also seems that Swiss plans do not fit in with the plans described in the appendix because there is generally no guarantee of the return by the employer. However, if there is a shortfall in the return of the assets in the plan, the employers and the employees seem in some cases to share that shortfall. Consequently, some employers would agree that they have a constructive or moral obligation to guarantee contributions, which might make these plans fall into the 'guaranteed' category.

23. As for Netherlands, it seems that contribution-based promises are not very common there, but insured plans, where the employer decrease the investment risk he exposed by entering into an agreement with an insurance company are used there.

24. Plans that would fall within the description in the appendix seem to be used in Bulgaria. It is however not clear from the response whether they are guaranteed plans or cash balance plans.

25. One respondent also points out that cash balance plans can be found in a larger sample of countries than those listed in the appendix, although they are probably less common that in the countries listed.

## Current accounting for these plans

26. There does seem to be diversity in practice in how these plans are accounted for. There seem to be a number of methods used and this confirms the need to address the accounting for these types of plans. For example, in one country the use of the methodology described by draft interpretation D9 seems to be the most common to account for these types of plans.

27. One of the responses identifies three accounting methods for the types of plans described in the appendix.

> i. The measurement is performed according to the wording of IAS 19: The DBO is measured by computing the ultimate or accrued benefit at the valuation date by a) projecting to the point of payment (death, disability, exit or retirement, as the case may be) the account balance using the expected investment return and then b) discounting that projected account balance back to the valuation date using the discount rate as defined in IAS 19.
>
> ii. For fully funded arrangements: The DBO is defined as the higher of a) the DBO of the defined benefit component (e.g. for a plan with a 2% p.a. minimum investment guarantee this benefit is projected at 2% p.a. to the point of

payment) and then discounted with the discount rate as defined in IAS 19, and b) the account balance. Only if the former exceeds the latter is the difference taken into P&L as pension expense in addition to the contribution payable. Otherwise, the pension expense is equal to the contribution payable. If this situation "normalizes" again at a later date, the additional charge is reversed out of P&L again. For arrangements that are in total or in part notional, the notional investment return is typically taken as interest cost and added to the contribution payable.

iii. The plan is split into two plans: The first plan is a defined contribution plan and is accounted for as such (here, a notional contribution or investment return are not permissible). The second plan consists of the defined benefit plan elements and is typically valued using option pricing or other stochastic methodology. This approach is the most uncommon of the three mentioned, not only because of its complexity but also because of its sensitivity to small changes in its assumption set. The methodology is already in common usage under other IFRSs – notably IFRS 2 – but its application to many cohorts of employees (rather than each type of annual grant as under IFRS 2) would make the calculations significantly more time-consuming that at present.

There are different variants of these accounting approaches but, by and large, the three methods cover existing practice.

28. Cash balance plans, at least in one country seem to be typically accounted for by:

Projecting the ultimate benefit payable, and then prorating, although some companies value the plans merely by using the account balance.

29. In another country defined contribution plans with a guaranteed return are accounted for in the following way:

> The market feels that valuing a DC plan with return guarantee like a pure DB promise makes little sense from an economic perspective and could hamper the 'faithful picture' principle. Most of DC plans with a return guarantee are not considered as back-end loaded plans (and this because the impact of future salary increases is not considered to assess whether the plan is back-end loaded). IAS 19's objective is to recognise:
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> a) a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and
>
> b) an expense when the entity consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.
>
> Where the return guarantee is virtually totally or for the major part covered by an insurance contract, many employers are tempted to (…and do) keep a DC accounting.

30. Cash balance plans, which are less common in the country mentioned in paragraph 29, are, in the respondents' belief, measured with a measurement method inspired by US GAAP rules:

> • Capitalisation of past contributions with the (best estimate of) the promised return
>
> • Discounted with the IAS 19 discount rate
>
> • No allowance for future (notional) contributions (or for the impact of future salary increases).

## Other issues

31. The respondents also raised other issues which may be beyond the scope of the work the Committee is taking on in this project. These are for example:

(a) the use of a ‘points’ system in Japan to accumulate benefits received. Here the ‘point’ is typically not related to actual salaries but based on a company specific table which is usually ranked by each employee’s capacity or position; and

(b) some respondents asked for guidance on target benefits.

## Appendix—types of ‘contribution-based promise’ plans

| **Type of plan** | **Basic features** | **Variations** | **Notes** | **Countries where common** |
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| 1. Plans with guaranteed return | The employee receives a pension based on the performance of the assets in the plan. The employer provides a guarantee of the minimum performance of the assets in the plan. This guarantee is based on the employer’s contributions to the plan.<br><br>Consequently, under these plans the employee receives a benefit that is the higher of the contributions plus the actual return on the assets in the plan and the guaranteed amount. | Typically the employer will guarantee a return of x% on contributions.<br><br>The guaranteed return of x% could be a numerical amount or may refer to a reference rate, for example the yield on government bonds in that country, an equity index or a price change index.<br><br>In some circumstances the employer might guarantee that the benefit will be no less than the contributions made, ie a return of 0%.<br><br>Usually the guarantee is given only on the employer’s contributions. | The employer may also guarantee a return on contributions made by employees, which may be voluntary (this seems however to be rare).<br><br>Some plans and the associated guarantees are contractual whereas some are required by law. | Germany, Netherlands, Belgium, Switzerland, Israel (Korea, Mexico) |

| Type of plan | Basic features | Variations | Notes | Countries where common |
|---|---|---|---|---|
| 2. ‘Cash balance plans’ | The employee receives a guaranteed benefit based on a specified return on notional’* contributions by the employer to the plan.<br><br>*See comment on ‘notional’ in the Notes column. | Typically the employer will guarantee a return of x% on contributions.<br><br>The guaranteed return of x% could be a numerical amount or may refer to a reference rate, for example the yield on government bonds in that country, an equity index or a price change index.<br><br>In some circumstances the employer might guarantee that the benefit will be no less than the contributions made, ie a return of 0%.<br><br>Usually the guarantee is given only on the employer’s contributions. | The plans may be funded or unfunded (for the unfunded plans the contributions and the return on the contributions are notional).<br><br>If these plans are funded they may be funded with assets that have a different return than the return promise by the plan). Any return on the assets in the plan that exceeds the amount guaranteed by the employer is an asset of the employer. | US, Japan, UK |