STAFF PAPER

December 2013

IASB Meeting

Project	**IAS 19 *Employee Benefits***
Paper topic	Discount rate: High quality corporate bonds–Update on the Interpretations Committee's decisions

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Introduction

1. In its February 2013 meeting, the IASB asked the IFRS Interpretations Committee (the Interpretations Committee) to clarify the requirements of IAS 19 on the determination of the discount rate for measuring post-employment benefits obligations.

2. The Interpretations Committee discussed the courses of action proposed by the staff in March, May, July and November 2013. However, in its November 2013 meeting, the Interpretations Committee decided to stop its project on the determination of the rate used to discount post-employment benefits obligation ('the discount rate project').

3. The purpose of this paper is to update the IASB on the Interpretations Committee's decisions on the discount rate project.

The issue

4. In October 2012, the Interpretations Committee was asked to clarify whether corporate bonds with an internationally recognised rating lower than 'AA' can be considered to be high quality corporate bonds (HQCB), in accordance with IAS 19 *Employee Benefits*.

5. The submitter stated that:

(a) according to paragraph 83 of IAS 19 the discount rate should be determined by reference to market yields at the end of the reporting period on HQCB;

(b) IAS 19 does not specify which corporate bonds qualify to be HQCB;

(c) according to prevailing opinion, listed corporate bonds are considered to be HQCB if they receive one of the two highest ratings given by an internationally recognised rating agency (eg 'AAA' and 'AA' from Standard and Poor's); and

(d) because of the financial crisis, the number of corporate bonds rated 'AAA' or 'AA' (AA-Bonds) has decreased significantly and they are traded less frequently. Consequently, single trades could influence market yield more significantly than in the past and eventually cause volatility in the market.

In the light of the above, the issue raised by the submitter is whether corporate bonds with a rating lower than 'AA' can be considered to be HQCB.

Summary of previous decisions

6. In its January 2013[1] meeting, the Interpretations Committee requested the staff to consult the IASB on this topic.

7. At its February 2013[2] meeting, the IASB agreed that:

(a) the objective for the determination of the discount rate is paragraph 84 of IAS 19, ie "the discount rate reflects the time value of money but not the actuarial or investment risk. Furthermore, the discount rate does not reflect the entity-specific credit risk borne by the entity's creditors, nor does it reflect the risk that future experience may differ from actuarial assumptions.";

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[1] See January 2013 IFRIC Update http://media.ifrs.org/2013/IFRIC/January/IFRICUpdateJan2013.pdf

[2] See February 2013 IASB Update http://media.ifrs.org/2013/IASB/February/IASB%20Update_February_2013_HTML.html#Matters-arising-IFRS-IC

(b) the Interpretations Committee should clarify the sentence "the discount rate reflects the time value of money but not the actuarial or investment risk" and that this sentence does not mean that the discount rate for post-employment benefit obligations should be a risk-free rate;

(c) the discount rate should reflect the credit risk of HQCB and that a reasonable interpretation of HQCB could be corporate bonds with minimal or very low credit risk; and

(d) the Interpretations Committee should propose amendments to IAS 19 to specify that when government bonds are used to determine the discount rate those bonds should be of high quality.

8. In its March 2013[3] meeting the Interpretations Committee requested the staff to consult appropriate experts[4] and to prepare proposals for a narrow-scope amendment to IAS 19 based on the results of the consultation with the IASB.

9. On the basis of the IASB's tentative decisions reported in paragraphs 7(a)-(d) of this paper, in May 2013[5] we proposed to delete paragraph 83, to modify paragraph 84 as follows:

84 ~~One actuarial assumption that has a material effect is the discount rate.~~ The <u>objective of the</u> discount rate <u>is to</u> reflect~~s~~ <u>only</u> the time value of money <u>and at most very low credit risk, the currency and the estimated term of the post-employment benefit obligations. The discount rate does not reflect</u> ~~but not~~ the actuarial or investment risk <u>of the plan assets (as defined in paragraph 28)</u>. Furthermore, the discount rate does not reflect the entity-specific credit risk borne by the entity's creditors, <u>and</u> nor does it reflect the risk that future experience may differ from actuarial assumptions.

and to issue the implementation guidance summarised in the following table.

[3] See March 2013 IFRIC Update http://media.ifrs.org/2013/IFRIC/March/IFRIC-Update-March-2013.htm#8

[4] We performed outreach on how determine the discount rate when there is no deep market for HQCB or high quality government bonds with capital market experts, actuaries and other IAS 19 experts. The results of this outreach are included in Agenda Paper 7 http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2013/May/AP07%20-%20IAS%2019%20Discount%20rate.pdf

[5] For further details on the narrow-scope amendment proposed by the Staff in May 2013, see Agenda Paper 7: http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2013/May/AP07%20-%20IAS%2019%20Discount%20rate.pdf

Issues	**Staff proposals**
Clarify the reference rate that best meets the objective proposed in paragraph 84 (ie time value of money plus very low credit risk)	Market yields on high quality bonds (ie corporate or government bonds with very low credit risk).
Clarify 'very low credit risk'	Bonds that receive one of the two highest credit ratings given by an internationally recognised rating agency.
The currency issue	The high quality bonds should be denominated in the same currency in which the benefits are to be paid.
The high quality government bonds issue	Government bonds with very low credit risk are high quality bonds, even if they have high currency risk (ie inflation). Government bonds with credit risk higher than very low are not high quality bonds (even if their currency risk is very low).
How to determine the discount rate if there is no deep market in high quality bonds	Construct a synthetic yield curve establishing a reliable reference yield curve (base curve) usually in the same currency of the liability and then either removing or adding the market premium for credit risk (credit risk adjustment).

10. In its May 2013[6] meeting, the Interpretations Committee considered the staff proposals summarised above and decided that they were too broad an amendment to IAS 19. Consequently, the Interpretations Committee requested the staff to refocus its work on an analysis of whether 'high quality' is a relative or an absolute concept.

11. In its July 2013[7] meeting, the Interpretations Committee noted that the term 'high quality' in paragraph 83 of IAS 19 reflects an absolute concept of credit quality,

[6] See May 2013 IFRIC Update http://media.ifrs.org/2013/IFRIC/May/IFRICUpdateMay2013.html#7

[7] See July IFRIC Update http://media.ifrs.org/2013/IFRIC/July/IFRIC-Update-July-2013.html#4

because the paragraph does not use the term 'the highest quality'. It also noted that issuing additional guidance on, or changing the requirements for, the determination of the discount rate would be too broad for it to address in an efficient manner. Consequently the Interpretations Committee tentatively decided not to add this issue to its agenda.

12. In its November 2013 meeting, the Interpretations Committee:

(a) considered the comments received[8] on the tentative agenda decision issued in July 2013;

(b) recommended that the issue should be addressed in the IASB's research project on discount rates; and

(c) confirmed its decision not to add this issue to its agenda.

13. We report below the Interpretations Committee's agenda decision issued in November 2013.

IAS 19 *Employee Benefits*—Actuarial assumptions: discount rate

The Interpretations Committee discussed a request for guidance on the determination of the rate used to discount post-employment benefit obligations. The submitter stated that:

a. according to paragraph 83 of IAS 19 *Employee Benefits* (2011) the discount rate should be determined by reference to market yields at the end of the reporting period on "high quality corporate bonds" (HQCB);
b. IAS 19 does not specify which corporate bonds qualify to be HQCB;
c. according to prevailing past practice, listed corporate bonds have usually been considered to be HQCB if they receive one of the two highest ratings given by a recognised rating agency (eg 'AAA' and 'AA'); and
d. because of the financial crisis, the number of corporate bonds rated 'AAA' or 'AA' has decreased in proportions that the submitter considers significant.

In the light of the points above, the submitter asked the Interpretations Committee whether corporate bonds with a rating lower than 'AA' can be considered to be HQCB.

[8] See Agenda Paper 4 http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2013/November/AP04%20-%20IAS%2019%20Discount%20rate.pdf

The Interpretations Committee observed that IAS 19 does not specify how to determine the market yields on HQCB, and in particular what grade of bonds should be designated as high quality. The Interpretations Committee considers that an entity should take into account the guidance in paragraphs 84 and 85 of IAS 19 (2011) in determining what corporate bonds can be considered to be HQCB. Paragraphs 84 and 85 of IAS 19 (2011) state that the discount rate:

a. reflects the time value of money but not the actuarial or investment risk;
b. does not reflect the entity-specific credit risk;
c. does not reflect the risk that future experience may differ from actuarial assumptions; and
d. reflects the currency and the estimated timing of benefit payments.

The Interpretations Committee further noted that 'high quality' as used in paragraph 83 of IAS 19 reflects an absolute concept of credit quality and not a concept of credit quality that is relative to a given population of corporate bonds, which would be the case, for example, if the paragraph used the term 'the highest quality'. Consequently, the Interpretations Committee observed that the concept of high quality should not change over time. Accordingly, a reduction in the number of HQCB should not result in a change to the concept of high quality. The Interpretations Committee does not expect that an entity's methods and techniques used for determining the discount rate so as to reflect the yields on HQCB will change significantly from period to period. Paragraphs 83 and 86 of IAS 19, respectively, contain requirements if the market in HQCB is no longer deep or if the market remains deep overall, but there is an insufficient number of HQCB beyond a certain maturity.

The Interpretations Committee also noted that:

a. paragraphs 144 and 145 of IAS 19 (2011) require an entity to disclose the significant actuarial assumptions used to determine the present value of the defined benefit obligation and a sensitivity analysis for each significant actuarial assumption;
b. the discount rate is typically a significant actuarial assumption; and
c. an entity shall disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements in accordance with paragraph 122 of IAS 1*Presentation of Financial Statements*; typically the identification of the HQCB population used as a basis to determine the discount rate requires the use of judgement, which may often have a significant effect on the entity's financial statements.

> The Interpretations Committee discussed this issue in several meetings and noted that issuing additional guidance on, or changing the requirements for, the determination of the discount rate would be too broad for it to address in an efficient manner. The Interpretations Committee therefore recommends that this issue should be addressed in the IASB's research project on discount rates. Consequently, the Interpretations Committee decided not to add this issue to its agenda.

14. We are providing the details of our work to the Staff working on the IASB's research project on discount rates.

Question for the IASB
Do you have any questions or comments on this update?