IFRS

STAFF PAPER

IFRS Interpretations Committee Meeting

March 2013

Project	**IAS 19 *Employee Benefits*—Discount rate**		
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Introduction and purpose of this paper

1. In October 2012, the IFRS Interpretations Committee (the Interpretations Committee) received a request for guidance on the determination of the rate used to discount post-employment obligations. In particular, the submitter asked the Interpretations Committee whether corporate bonds with an internationally recognised rating lower than 'AA' can be considered to be high quality corporate bonds (HQCB).

2. In its November 2012 meeting, the Interpretations Committee noted that:

   (a) the predominant past practice has been to consider corporate bonds to be high quality if they receive one of the two highest ratings given by an internationally recognised rating agency (i.e. 'AAA' and 'AA').

   (b) IAS 19 does not specify how to determine the market yields on HQCB, and in particular it does not specify what grade of bonds should be designated as high quality.

   (c) an entity shall apply judgement in determining what the current market yields on HQCB are, taking into account the guidance in paragraphs 84 and 85 of IAS 19; and

(d) an entity's policy for determining the discount rate should be applied consistently over time.

3. In its January 20131 meeting, the Interpretations Committee:

(a) expressed support for the June 2005 Interpretations Committee agenda decision that, in determining the discount rate, an entity shall include HQCB issued by entities operating in other countries, provided that these bonds are issued in the currency in which the benefits are to be paid. A consequence of this view is that for a liability expressed in euros, the deepness of the market of HQCB should be assessed at the Eurozone level; and

(b) requested the staff to consult with the IASB:

(i) to confirm that the underlying principle for the determination of the discount rate is set out in paragraph 84 of IAS 19 (2011), and is described as "the discount rate reflects the time value of money but not the actuarial or investment risk";

(ii) to provide clarity about this sentence in paragraph 84;

(iii) to ask whether this sentence in paragraph 84 means that the objective for the discount rate for post-employment benefit obligations should be a risk-free rate; and

(iv) to confirm that IAS 19 should be amended to clarify that when government bonds are used to establish the discount rate in the absence of HQCBs, those government bonds used must themselves be high quality.

4. The purpose of this paper is:

(a) to provide a summary of the issue;

(b) to provide the results of the consultation with the IASB on this issue;

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

(c) to illustrate to the Interpretations Committee our proposed next steps on this issue; and

(d) to ask the Interpretations Committee members whether they have any comments on this issue.

Summary of the issue

5. The submitter states 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 are traded less frequently. Consequently, single trades could influence market yield more significantly than in the past and eventually distort the observable market rate, which would in turn distort the discount rate.

In the light of the above, the submitter asked whether corporate bonds with a rating lower than ‘AA’ can be considered to be HQCB.

Results of the consultation with IASB

6. At the February 2013 IASB meeting[2], the we asked the IASB if it agreed:

[2] http://www.ifrs.org/Meetings/Pages/IASBFebruary2013.aspx See agenda paper 9A.

(a) that 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.";

(b) that 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) that 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.

(d) that 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.

The majority of the IASB members agreed.

Proposed next steps

7. We are going to bring to the May 2013 Interpretation Committee meeting a draft amendment to IAS 19 (ie a narrow scope amendment) that will reflect the IASB's direction above.

8. We think that in this draft amendment we should also clarify that: in determining the discount rate, an entity shall include corporate bonds with minimal or very low credit risk issued in other countries, provided that these bonds are issued in the currency in which the benefits are to be paid.

9. In our view, in this narrow scope amendment we should provide guidance for determining the discount rate when there is no deep market for corporate bonds with minimal or very low credit risk and when government bonds are not "high quality". Our preliminary view is that: in this situation, an entity should use the government bonds and adjust the yield of these bonds removing the market

premium for the additional credit risk. In other words the entity should construct a synthetic yield curve.

Questions for the Interpretations Committee
1. Do the Interpretations Committee members have any comments on our proposed next steps? .

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