STAFF PAPER

12–13 November 2013

IFRS Interpretations Committee Meeting

Project	IAS 19 *Employee Benefits*		
Paper topic	Distinction of components—Employee benefit plans with a guaranteed return on contributions or notional contributions		
CONTACT(S)	Kazuhiro Sakaguchi	ksakaguchi@ifrs.org	+44 (0)20 7246 6930
	Manuel Kapsis	mkapsis@ifrs.org	+44 (0)20 7246 6459

Introduction

1. This paper discusses distinction between fixed and variable components for employee benefit plans that fall within the Interpretations Committee's agreed work.

2. We have provided a sample of benefit promise designs in Appendix A. Throughout this paper, we will refer to these benefit promises to illustrate particular points.

Background

3. IAS 19 requires that an entity accounts for the defined benefit obligation by:

   (a) projecting the defined benefit forward to determine the ultimate cost;

   (b) attributing the ultimate cost to periods of service; and then

   (c) discounting the amounts related to current and prior service using a specified discount rate.

4. For employee benefit plans with a guaranteed return on contributions or notional contributions, many argue that this method of accounting for the defined benefit obligation results in an amount that does not faithfully represent the economics.

5. Consequently, the Interpretations Committee decided to develop a new accounting model that applies to employee benefit plans with a guaranteed return on contributions or notional contributions based on the approach in IFRIC Draft Interpretation D9 *Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions* published in 2004 ('the D9 approach').

The distinction between the fixed and variable components

6. The D9 approach proposed that an entity split a benefit promise within its scope into the component that depends on a fixed return and the component that depends on a variable return. The fixed component would have been measured in accordance with the defined benefit requirements of IAS 19 and the variable component would have been measured at the fair value of the underlying asset. D9 also addressed promises that were a combination of the above two benefits. Specifically if an entity promised the higher of a fixed return and a variable return, then the benefit would be measured at the higher of the two.

17. At the time when D9 was published, the IFRIC had concluded that the defined benefit methodology set out in IAS 19 did not present problems for fixed benefits. At least, no more problems than that methodology would present for final salary defined benefit promises. However the IFRIC concluded that the use of the discount rate prescribed in IAS 19 was inappropriate for variable benefits that depend on future returns on actual or notional assets.

18. In effect, the distinction in D9 would subdivide the benefit promises within the agreed scope further and apply the existing recognition and measurement requirements to the fixed component and measure the variable component at the fair value of the underlying assets. In D9, the variable component was based on whether the return on contributions was specified by a reference to the market rate on a particular asset (or group of assets, such as an index). As expressed in comment letters to D9, and the subsequent work carried out by the IFRIC, the distinction set out in D9 was not clear, particularly for some types of return and complex benefit structures.

19. When the IASB discussed D9 as part of its project to improve IAS 19, it found it difficult to justify why different measurement bases would be needed for benefits with a variable return and benefits with a fixed return. The IASB found it difficult to classify benefit structures that didn't fall neatly within the fixed/variable approach in D9. These benefit structures included benefits that were based on contributions plus the yield to maturity of a reference bond with resets, and benefits that had combinations of caps and guarantees, and benefits that were based on a fixed rate plus a variable rate (composite benefits).

20. The IASB determined that distinguishing between benefits based on whether the return was fixed or variable was arbitrary, complex and would result in different accounting for economically similar benefits. The IASB concluded that all benefits that could be expressed in current salary terms should be measured the same, with the remaining benefits (ie those that depended on future salary) measured using the existing IAS 19 methodology.

21. As noted in the comment letters to D9, and the subsequent work carried out by the IFRIC and the IASB, it was not clear how benefits that promise a return of **both** a variable return and a fixed return would be accounted for under the D9 approach. That is, a benefit that promises not one or the other return (as would be the case in a 'higher of' plan), but a composite of both.

22. Promises that return a composite benefit exacerbate the issues of classification, as the variable and fixed returns become intermingled as they compound. Arguably, the fixed/variable approach does not contemplate the accounting for these types of benefits. In our view, it is not possible to split these plans into a variable and fixed component, because the benefit at any point in time is a compound function of both fixed and variable returns. Therefore, plans that promise a return of a variable return **plus** a fixed return should be accounted for in their entirety either in accordance with the existing requirements for defined benefit plans, or at the

fair value of the underlying replicating asset[1]. That is, they should not be split between the two components.

23. In our view, the classification problems arise because the fixed and variable components were both defined positively in D9, and thus it was not clear that the two categories were mutually exclusive. Thus the difficulties of the classification could be alleviated by simply defining one category positively and defining the other category as the residual. We think that the Interpretations Committee has two options to address this issue:

    (a) define the fixed component positively, with the variable component as the residual.

    (b) define the variable component positively, with the fixed component as the residual.

24. The defined benefit plan classification in IAS 19 is the default classification if a benefit promises does not meet the definition of any other classification. Following from that general approach, in our view the variable component should be defined positively and thus everything else, including the 'non-variable' component of a D9 plan, would be measured using the existing methodology for defined benefit plans.

25. However, as the IASB discovered, identifying the defining characteristic of the variable component is conceptually problematic. Thus, attempting to define the variable component positively is likely to be difficult without arbitrary rules. In particular, the IASB found it difficult to justify why a promise of fixed returns should be accounted for differently to a promise of variable returns, and how to classify benefits that were based on inflation or wage indices. The IASB considered whether benefits that are based on inflation or wage indices are economically similar to promises with a variable return, promises with a fixed return or promises based on final salary. The existing measurement requirements in IAS 19 already consider inflation and wage price changes through the salary

[1] We refer to a replicating asset here to distinguish between the asset that is being used as the reference for the variable return and an asset that would replicate the features of this particular type of promise. When measuring these types of promises, the measure should reflect the latter and not the former.

progression assumption. The IASB concluded that it would be difficult to distinguish what price changes should be included in the variable component and thus all plans within the scope of D9 should be measured using the same method.

Alternatives

26. In selecting the D9 approach, the Interpretations Committee decided that the defining characteristic should lie somewhere between promises with a full fixed return and promises with a return based on the plan assets. Therefore the Interpretations Committee might define the variable component as follows (from smallest set of promises to largest set):

    (a) **Promises of a return on contributions based on the return on *actual plan assets held***. All other promises would fall within the 'non-variable' component and be measured using the existing defined benefit accounting. In effect, this approach would split the plan into a defined contribution component (the variable component) and a defined benefit component (the non-variable component).

    (b) **Promises of a return on contributions based on the return on *a specified class of assets***. This specified class of assets would need to be defined by a set of criteria (or rules in the standard), and might include classes such as equities, bonds, and the indices based on these assets. All other promises would fall within the 'non-variable' component and be measured using the existing defined benefit accounting.

    (c) **Promises of a return on contributions based on *any variability that includes a market reference***. Thus, only promises based on a fixed return, or non-market variability such as the entity's performance, would fall in the 'non-variable' component and be measured using the existing defined benefit accounting. This definition of the variable component would include promises of a return based on inflation or wage indices, and composite benefits that include a market reference.

Promises of a return on contributions based on the return on actual plan assets held

27. This option would be the simplest of the alternatives to apply. However, it would only apply to a very narrow set of promises, and would exclude any promises based on returns on notional contributions.

28. Combined with the measurement of any other component using the existing defined benefit requirements, this option would result in the measurement of a 'higher-of' promise at the higher of the plan assets or the 'non-variable' defined benefit component. Importantly, all other types of promises within the scope of this project would fall within the 'non-variable' component, including promises of a return on asset(s) that do not meet the definition of plan assets, even though the economics of these promises might be similar.

29. For example, if the plan assets are invested in the S&P 500 index, a promise would fall within the definition of the variable component if that promise is defined by the return on the plan assets held, however if a promise is defined by the return on the S&P 500 index directly, then the latter promise would not meet the definition of a variable component, even though the plan assets are invested in the S&P 500 index. For the latter, the promise will need to be measured using the existing projected unit credit method.

30. In our view the benefits of this approach are its relative simplicity, and the reference to plan assets which distinguishes promises based on whether the return on the contributions is linked to the assets that the plan actually invests in, which focuses on the plans that the Interpretations Committee is primarily concerned about (ie plans that would meet the definition of a defined contribution plan but for some other feature).

31. However, this approach would not address plans with a return on a specified index, even if the entity holds the matching assets, and some of the more complex benefit structures, including composite benefits. Complex benefit structures that cannot be deconstructed would be accounted for as defined benefit plans in full, even if they had features that resembled a return on contributions or notional contributions. Thus, composite benefits would be accounted for as defined

benefit plans, because the return on contributions required is not equal to the return on plan assets.

Promises of a return on contributions based on the return on a specified class of assets

32. This alternative would require the Interpretations Committee to develop a definition of the types of variability that should be accounted for using different recognition and measurement requirements. The basis for this approach would be that the defined benefit methodology set out in IAS 19 already envisages some types of variability, such as inflation. However, the methodology set out in IAS 19 is clearly inappropriate for other types of variability, including returns on equity instruments.

33. The Discussion Paper noted that some take the view that IAS 19 requires entities to measure the obligation for a benefit that depends on future returns on assets by projecting forward the benefit using its best estimate of the rate of return on the specified assets and then discounting that amount using a high quality corporate bond rate. However, this discount rate is not appropriate for benefits that depend on future returns on assets because it does not reflect the risk of those assets.

34. Some think that applying this method to benefits that depend on future returns on assets does not provide useful information. They think it is equivalent to valuing CU100 of equities by projecting CU100 forward at the expected rate of return on equities and discounting that amount to a present value at the rate of return on high quality corporate bonds. That present value will not equal CU100. However, that problem would exist for any promise that was not based on the rate of return on high quality corporate bonds, including inflation indexed promises, promises of a variable return, promises of a fixed return or promises of a final salary plan.

35. In order to pursue this approach, the Interpretations Committee would have to decide on various types of variability. For example, some reference indices are closely correlated with expectations of future salary, including inflation and wage related indices. Arguably, inflation is a component of the salary increase

assumption, therefore it might be appropriate to account for such increases under the existing methodology of IAS 19.

36. Another example is a plan that promises contributions plus a return that was reset each year to the market yield–to-maturity of a bond index. While the yield-to-maturity at the beginning of the year represents a market value, subsequent changes to the market value of the underlying bond are not taken into account. Some respondents to D9 suggested that such promises would be better accounted for under the defined benefit methodology. However, it could also be argued that the asset underlying this benefit was not the asset used as the basis for the rate of indexation, but an asset (such as a derivative or loan) with the same reference rate and reset features. That is, this obligation could be replicated by another asset or group of assets.

37. Some respondents to D9 suggested that the distinction should be based on whether the promised return is a reference to assets that are investible. However, in our view, as long as the reference is based on a market price, then the price changes could be replicated by a combination of assets, or through a derivative (either market index future, or custom made over the counter derivative).

Promises of a return on contributions based on any variability that includes a market reference

38. At the other end of the spectrum, this alternative would define the variable component based on any return on contributions that is based on a market reference. Pure fixed returns (or promises with salary risk beyond the scope of this project) would be accounted for under the existing defined benefit methodology.

39. The advantage of such an approach is its relative simplicity, however its scope is significantly larger than the other alternatives, and would include any variability if it can be expressed by reference to a market price. This definition of the variable component would include promises of a return based on inflation or wage indices, and composite benefits that include a market reference.

40. As noted above, promises of returns based on inflation or wage indices might be economically similar to final salary promises, therefore a consequence of this

approach would be different accounting for a final salary promise and a promise that is based on a wage or inflation index.

Staff recommendation

41. In our view, we would not recommend that the Interpretations Committee define the variable component by reference to one or more types of assets classes (26(b)). That alternative would require the Interpretations Committee to identify and define a list of the types of risk or variable returns that would be eligible, as opposed to identifying a principle for the basis of the distinction. We do not recommend this alternative because the outcomes would depend on an arbitrary set of rules, and it will be difficult to define those rules in a manner that is robust enough to ensure consistent application or comparable outcomes.

42. We have analysed the effect of the two remaining alternatives on sample set of promises described in Appendix A of this paper, and summarise the advantages and disadvantages as follows:

    (a) If the variable component is defined by reference to the actual return on plan assets, then it would affect a limited set of promises, and the distinction would be consistent with the existing defined contribution/defined benefit distinction in IAS 19. However the measurement of economically similar promises would be different.

    (b) If the variable component is defined as any variable return that includes a market reference, then it would result in a more faithful representation of a larger set of promises. However, that set of promises may include many promises for which the current accounting is not considered troublesome.

43. In the staff's view, we think that defining the variable component as a return that references the actual plan assets would strike the best balance between improving the accounting for troublesome promises and limiting the effect of the change.

Question 2

Does the Interpretations Committee agree with the staff recommendation to define the variable component as a return that is defined based on the actual return on plan assets?

Appendix A—Analysis of how the proposed distinction is applied to various types of benefit promises

	Description of promises	Variable component is actual return on plan assets held	Variable component is any promised return that includes market reference	2008 DP
1	**Defined Contribution** The employer promises to make contributions into a fund of 5% of the employee's current salary for each year of service. The benefit promise at retirement is a lump sum equal to the contributions paid plus the actual investment returns on those contributions. If defined contributions are not expected to be paid within 12 months, paragraph 52 requires that these are discounted to present value using the IAS 19 discount rate requirements.	Defined contribution	Defined contribution	Contribution based
2	**Final Salary Plan** The employer promises to pay the employee at retirement an amount equal to 5% of the employee's salary in the final year of employment for each year of service. This benefit is equivalent to a promise to make contributions of 5% of the employee's current salary during the current reporting period for each year of service. And at retirement the employee receives the 5% contributions plus the increase in the employee's salary.	Defined benefit	Defined benefit	Defined benefit
	2A – Alternative - The benefit is a lump sum benefit at retirement equal to the number of years' service multiplied by 5% of the average of the employee's salary in the most recent (ie final) three years of service.	Defined benefit	Defined benefit	Defined benefit
3	**Fixed return of 0%** The employer promises to make notional contributions of 5% of the employee's current salary for each year of service.	Defined benefit	Defined benefit	Contribution based

	The benefit promise at retirement is a lump sum equal to the contributions plus a fixed return on the contributions of 0% per year. This benefit promise would be equivalent to a promise of a lump sum at retirement equal to 5% of the career average of the employee's salary for each year of service.			
	3A – Alternative - The employer promises to make notional contributions of 5% of the average of the employee's salary in the most recent three years of service. The benefit promise at retirement is a lump sum equal to the contributions paid.	Defined benefit	Defined benefit	Contribution based
4	**Fixed return of 3%** The same as **Promise 3** but with a 3% fixed return on contributions per year.	Defined benefit	Defined benefit	Contribution based
5	**Variable return of price index** The same as **Promise 3** but with a price index (CPI, wage index etc) return on contributions per year.	Defined benefit	Fair value of replicating assets	Contribution based
6	**Variable return of equity index** The same as **Promise 3** but with an equity index return on contributions per year.	Defined benefit	Fair value of replicating assets	Contribution based
	Combinations			
6	**Higher of** The employer promises to make (notional) contributions of 5 per cent of the employee's salary during the current reporting period for each year of service. The benefit promise at retirement is a lump sum equal to the contributions plus any return on plan assets **or** 3 per cent, **whichever is higher**.	Higher of variable (fair value of plan assets) and non-variable components (defined benefit)	Higher of variable (fair value of replicating assets) and non-variable components (defined benefit)	Contribution based
	6A – Alternative – The benefit promise at retirement is a lump sum equal to the contributions increased with the compound return on a specified equity index **or** 3 per cent, **whichever is**	Defined benefit	Higher of variable (fair value of replicating assets) and non-variable	Contribution based

	higher.		components (defined benefit)	
7	**Composite over time** The benefit is a lump sum benefit at retirement equal to the number of years' service multiplied by 5 per cent of the average of the employee's salary in the most recent (ie final) three years of service, plus 5 per cent of the employee's current salary for any additional years. This benefit is equivalent to a promise to make a contribution of 5% of current salary plus a variable return based on salary (ie **Promise 1 Alternative**) for the first three years and a fixed return of 0% on current salary for all other years (ie **Promise 3**).	Defined benefit	Defined benefit	Defined benefit for first three years and contribution based for any subsequent years.
8	**Additive composite** The employer promises to make (notional) contributions of 5 per cent of the employee's salary during the current reporting period for each year of service. The benefit promise at retirement is a lump sum equal to the contributions increased with the compound return on a specified equity index **plus** 3 per cent.	Defined benefit	Fair value of replicating assets	Contribution based
	Demographic risk			
12	The employer promises to contribute into a separate fund 5 per cent of the employee's salary for each year of service. The lump sum at retirement, which is equal to the accumulated contributions plus the investment returns they earn, is converted into a pension at a fixed annuity rate (ie the cost of buying a pension is fixed when the promise is made, rather than being determined by the market rates at retirement date). That pension amount is payable in monthly instalments for the life of the retired employee.	Defined benefit	Defined benefit	Contribution based

13	The employer promises to contribute CU100,000[2] into a separate fund on the first day of service. The lump sum at retirement is the contribution of CU100,000, plus a fixed return of 0 per cent. The lump sum is converted into a pension at a fixed annuity rate (ie the cost of buying a pension is fixed when the promise is made, rather than being determined by the market rates at retirement date). This generates a benefit of CU1,000 per year for the life of the retired employee.	Defined benefit	Defined benefit	Contribution based
14	The employer promises a benefit of CU1,000 per year for each year after the employee retires until his death, regardless of the service period of the employee.	Defined benefit	Defined benefit	Contribution based

[2] Currency amounts are denominated in 'currency units' (CU) in this paper.