

STAFF PAPER

12–13 November 2013

IFRS Interpretations Committee Meeting

Project	IAS 19 <i>Employee Benefits</i>		
Paper topic	Recognition and measurement—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

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*.

Introduction

1. This paper discusses recognition and measurement for employee benefit plans that fall within the Interpretations Committee’s agreed scope, specifically recognition and measurement for:
 - (a) non-variable components (paragraphs 3—5);
 - (b) variable components (paragraphs 6—38); and
 - (c) ‘higher of’ options (paragraphs 39—44).

Appendix A includes a diagram of the measurement approach as per the staff recommendations.

2. The distinction between variable and non-variable components is discussed in Agenda Paper 2B. The staff do not think that the outcome of that discussion will affect the Interpretations Committee’s decisions regarding measurement.

Recognition and measurement for the non-variable component

3. For a benefit promise with a fixed return, D9 proposed the application of the defined benefit methodology set out in IAS 19.

4. Agenda Paper 2B recommends that, instead of defining the ‘fixed’ component positively, promises that do not meet the definition of the variable component should fall within the non-variable component. Thus, the promises within the non-variable component might include features that are not pure ‘fixed’ returns, depending on the Interpretations Committee’s conclusions on the distinction.
5. The current accounting for fixed return promises has not been identified as problematic. In addition, the Interpretations Committee has previously indicated that the proposals developed should retain consistency with the current accounting as much as possible. Thus, we recommend that the Interpretations Committee should retain the existing defined benefit methodology for the non-variable component of employee benefit plans that fall within the Interpretations Committee’s agreed scope.

Question 1

Does the Interpretations Committee agree that the defined benefit methodology set out in IAS 19 should be applied to the non-variable component of employee benefit plans that fall within the Interpretations Committee’s agreed scope?

Recognition and measurement for the variable component

6. D9 concluded that a promised return (that is either a fixed return or an asset-based return or a combination of those) is a defined benefit plan under IAS 19. For a benefit promise with an asset-based return, D9 proposed that an entity shall measure the liability at the reporting date at the fair value of the assets upon which the benefit is specified. Under this measurement:
 - (a) if the benefits are unvested at the reporting date, the measurement of the plan liability shall be determined by the extent to which they are expected to vest in the future. As a result, if there is a high probability that the benefits will not vest, then an entity may recognise a net asset arising from the plan.

- (b) if the benefits include a specified margin on future asset returns, then the plan liability is measured at the fair value of the assets plus or minus the effect of the margin.
7. Comments received on D9 raised a number of concerns regarding the recognition and measurement requirements. Concerns raised included how benefits that promised a variable return plus a fixed margin would be measured and whether an entity should reflect credit risk in the measurement.
 8. In addition to the concerns raised about measurement above, the IASB also noted the tension between the attribution requirements for defined contribution plans and defined benefit plans. Specifically, the attribution of defined contribution plans does not consider back-end loading features (such as when the percentage contribution of salary increases with service). Therefore, the IASB found it difficult to reconcile the attribution of the variable component and the fixed component of D9 plans.
 9. All of the points above are analysed in the following sections:
 - (a) measurement at fair value (paragraphs 10–14);
 - (b) unvested benefits (paragraphs 15–18);
 - (c) benefits that include a margin (paragraphs 19–23);
 - (d) credit risk (paragraphs 24–26);
 - (e) attribution of benefits to periods of service (paragraphs 27 – 38);

Measurement at fair value

10. Under the defined benefit methodology set out in IAS 19, a benefit promise is projected forward at an expected rate of return on the assets or index and discounted to a present value using the rate specified in IAS 19 (ie rate on high quality corporate bonds or government bonds). However, there are problems with this approach because the defined benefit methodology in IAS 19 is designed for benefits that do not depend on future returns on assets.

11. When the IFRIC developed D9, it followed the approach required by paragraph 85(b) of IAS 19. That paragraph is equivalent to paragraph 88(b) of current IAS 19, which states that:
- Actuarial assumptions reflect future benefit changes that are set out in the formal terms of a plan (or a constructive obligation that goes beyond those terms) at the end of the reporting period. This is the case if, for example:
- (a) ...
 - (b) the entity is obliged, by either the formal terms of a plan (or a constructive obligation that goes beyond those terms) or legislation, to use any surplus in the plan for the benefit of plan participants (see paragraph 108(c)); or
 - (c) ...
12. The consequence of this requirement is that the *present value* of the plan liability for the use of the ‘surplus’ (ie the surplus in the plan before considering how it must be used) is the amount of the ‘surplus’ at the reporting date.¹ The IFRIC agreed that the same principle applies to any benefits that depend on future returns on assets. In other words, the plan liability for such benefits should be determined by the **fair value** at the reporting date of the underlying reference assets.
13. We agree with the conclusion by the IFRIC for the reasons it stated at that time and, therefore, think that the same approach should be applied to the variable component of the plans that fall within the Interpretations Committee’s agreed work.
14. Measuring the liability at the reporting date at the fair value of the underlying reference assets means that no projection forward of the benefits shall be made, and discounting of the benefit is not therefore required. Consequently the accounting mismatch from using a discount rate to discount the benefit obligation that differs from the expected return on plan assets does not arise.

¹ Otherwise, IAS 19 would require the plan liability to be measured based on a projection forward of the expected future returns on the ‘surplus’ discounted back to a present value, rather than on the value of the ‘surplus’ at the reporting date.

Unvested benefits at the reporting date

15. D9 proposed that, if a benefit is unvested at the reporting date, the measurement of the plan liability shall be determined by the extent to which they are expected to vest in the future.
16. When developing D9 the IFRIC considered whether a plan liability for benefits that depend on future asset returns arises if the benefits are not vested. The IFRIC agreed that it does so because (1) IAS 19 requires unvested benefits to be accrued over the service lives of the employees and (2) the plan liability set up for the benefits does not represent the amount that would be paid if employees left service at the reporting date. Rather, it is the present value of the amount expected to be paid at the date the employees are expected to leave. The possibility that some benefits may not vest is reflected in the measurement of the plan liability through actuarial assumptions.
17. We agree with the conclusion by the IFRIC for the reasons it stated at that time and, therefore, think that the same approach should be applied to the variable component of the plans that fall within the Interpretations Committee's agreed work.
18. This means that an entity would measure the plan liability for the variable component of such plans at fair value by taking into account the probability that the benefits will vest.

Benefits that include a margin

19. An example of a benefit that includes a specified margin on future asset returns is a benefit that includes a promise of the return on an equity index plus two hundred basis points.
20. Agenda Paper 2B notes that benefits that include a combined benefit cannot be separated, and thus would either be classified in totality as variable or non-variable. Therefore, this analysis is only relevant if the Interpretations Committee decides that these benefits should be included in the variable component (if the Interpretations Committee decides that these should be included in the non-

variable component, then the existing projected unit credit method of IAS 19 would apply).

21. D9 proposed that, if a benefit includes a specified margin on future asset returns, when the plan liability is measured the effect of the margin shall be added to or deducted from, as appropriate, the fair value of the assets at the reporting date. Many respondents to D9 were unsure how the proposed approach would be applied. Concerns were raised about how the effect of the margin should be measured.
22. We do not think there is any reason why the general principle identified for the measurement of the variable component should not be applied to such promises. The approach would require an entity to measure the variable component at the fair value of an equivalent asset with the same features (replication). Such a replication approach would be more difficult to apply, but as noted in Agenda Paper 2B, the compounding effect of two combined returns cannot be easily separated.
23. Consequently, we recommend that the general principle, that the benefit should be measured at the fair value of the reference asset, identified for the measurement of the variable component should be applied to benefits that include a margin.

Credit risk

24. Respondents to D9 noted that measuring benefits that are based on a return on assets at the fair value of the underlying assets results in the measurement of those liabilities at the risk free rate if those liabilities are not funded by the same assets. If the plan is unfunded, then an entity would have to obtain the underlying assets to distribute the value to the employees. Arguably, entity specific credit risk is not considered in the defined benefit methodology of IAS 19, however the discount rate requirements of that methodology might include some element of credit risk.
25. We rejected the following alternatives:
 - (a) Requiring entity specific credit risk to be considered in the measurement. This would be consistent with a fair value measurement of the liability (ie

the price that the entity would be able to transfer the liability at). However this would be a considerable departure from the requirements of IAS 19. The IASB's preliminary views in the 2008 Discussion Paper were that credit risk should be included, in particular because the scope of the benefits that would be measured at fair value included promises of fixed returns on contributions. We think reflecting entity specific credit risk would be less of a concern because none of the options being considered include pure fixed returns in the definition of the variable component.

- (b) Requiring some margin for credit risk consistent with the discount rate used to measure defined benefit plans. While this would be consistent with IAS 19, we think that such an approach would be complex and the benefits of measuring this component of credit risk would not outweigh the costs.

- 26. In our view, credit risk should not be included in the measurement of the liability, and therefore the liability for the variable component should be measured at the fair value of the underlying replicating asset, and not the fair value of the entity's liability. We acknowledge that this would be inconsistent with the discount rate requirement in IAS 19, however we think the costs of reflected credit risk on a consistent basis would outweigh the benefits for the variable component. Consequently we recommend that the fair value of the reference assets is used to measure the liability instead.

Attribution of benefits to periods of service

- 27. For the purpose of this section, we separate the variable component into two further components—the contribution component and the promised return component. We note that the analysis below takes the same approach as that of Agenda Paper 6A for the June 2007 IASB meeting in developing the 2008 Discussion Paper.

Contribution component

- 28. In relation to the contribution component, the benefit that should be allocated to any period of service would be the contribution required for that period. In

IAS 19 terminology, this is equivalent to requiring the benefit to be allocated in accordance with the benefit formula. Doing so would be consistent with the treatment of benefits under a defined contribution plan.

29. For example, a defined contribution plan promises a benefit of contributions of 5 per cent of current salary for the first ten years of service and 10 per cent for the next ten years. In this example, the fact that the benefits earned in later periods are higher than the benefits earned in early periods would not affect the accounting. Entities would not make an accrual in the early periods for the higher benefits to be earned in the later periods. In contrast, if the plan were a defined benefit promise, IAS 19 would require the benefits to be attributed to periods of service on a straight-line basis (because the benefit is back-end loaded).
30. Consider (a) a benefit of CU100 per year that does not vest until the end of 20 years and (b) a benefit of CU2,000 that is earned and vests at the end of 20 years. Although they provide economically the same benefits, if the liability recognised is based on the benefit formula, (a) would result in a liability of 100 each year and (b) would result in no liability recognised until the 20th year.
31. We acknowledge that sticking to the benefit formula could result in an entity not recognising some unvested benefits. However, the risk applies only to unvested benefits. If sticking to the benefit formula, all vested benefits attributed to past service are recognised according to the benefit formula.
32. In paper 2A, we argued that unvested benefits should be treated as giving rise to a liability. That might imply that we should not allow entities to avoid recognising that liability by always sticking to the benefit formula. In our view, however, departing from the benefit formula for the contribution component of an asset-based return would complicate the measurement of both the contribution and the promised return components.
33. We recommended that the variable component should be measured at the fair value of the underlying reference assets. However, if the contributions are allocated other than in accordance with the benefit formula (ie attributed to periods of service taking into account unvested benefits), the promised return component would be measured as the fair value of a promised return on attributed

contributions rather than the fair value of underlying reference assets. We think that this would add complexity to the approach without giving more meaningful information. For example, to measure the fair value of attributed contributions, entities would need to decide whether the attributed benefit includes the effect of expected future salary increases. This question does not arise when the contribution component is allocated in accordance with the benefit formula.

34. Finally, allocating the contribution component other than in accordance with the benefit formula would weaken the comparison between the variable component of a benefit promise and a defined contribution promise.

Promised return component

35. The benefit promises within the scope of this project always include a promised return on contributions or notional contributions. Accordingly, the benefit given by the promised return on a contribution must be allocated to the period in accordance with the benefit formula, consistent with the attribution of the contribution component.

36. The implications of this are as follows. At any point in time, the variable component comprises:

- (a) a promised return on contributions for past and current periods; and
- (b) a promised return on contributions in future periods.

37. Under the staff proposal above, a liability for the promised return in (a) will be recognised in the periods for which the related contributions are required. No liability will be recognised for the promised return in (b) because the benefit of the contributions is attributed to future periods of service.

Conclusion

38. On the basis of the analysis above, we think that the variable component of a benefit promise is allocated to periods of service in line with the benefit formula.

Question 2

For the variable component of the employee benefit plans that fall within the agreed scope, does the Interpretations Committee agree that:

- (a) the plan liability should be determined by the fair value at the reporting date of the underlying reference assets?
- (b) if a benefit is unvested at the reporting date, the measurement of the plan liability shall be determined by the extent to which they are expected to vest in the future?
- (c) the general principle identified for the measurement of the variable component should be applied to benefits that include a margin? This would require the entity to measure the variable component at the fair value of an asset that replicates the same features. (only relevant if the Interpretations Committee decides that such benefits are included in the definition of the variable component in 2B)
- (d) the measurement of the variable component should not consider credit risk, and therefore it should be measured based on the fair value of the underlying assets without adjustment?
- (e) the variable component of a benefit promise is allocated to periods of service in line with the benefit formula?

‘Higher of’ options

39. In November 2012, the Interpretations Committee discussed the measurement of the ‘higher-of’ promises and tentatively decided that such benefits should be measured at their intrinsic value. Notwithstanding the Interpretations Committee’s tentative decision, we wanted to highlight two matters for its attention:

- (a) Objections raised at the September 2013 IASB meeting (paragraphs 40-42); and

- (b) The measurement of a promise of the ‘higher-of’ two variable components based on decisions made at this meeting (paragraphs 43-44).

Objections raised at the September 2013 IASB meeting

40. At the Interpretations Committee update session of the September 2013 IASB meeting, one IASB member raised objections to the tentative decision regarding ‘higher-of’ plans. That IASB member thought that measuring ‘higher-of’ promises at the intrinsic value would be potentially misleading.
41. Comment letters to D9 noted that the value of an option or guarantee would not be faithfully represented if measured at intrinsic value. This would especially be the case if the variable component was highly volatile and the exercise date of the option or the effective date of the guarantee was long-term. Under such circumstances the time value of the option could be significant and the intrinsic value might be misleading to investors. In the 2008 Discussion Paper, the IASB’s preliminary view was that any embedded guarantees or options should be measured at their fair value.
42. The Interpretations Committee could retain its existing tentative decision regarding ‘higher-of’ promises, and solicit comments as to whether such an approach would be appropriate or whether an approach that considers the time-value of the option would achieve a better balance of the benefits and costs of measurement. Another possibility would be to consider additional disclosures that would provide users with the tools to estimate the time value. For example, the intrinsic value of the option could be disclosed, along with the value of both components. We plan to discuss disclosure at a future meeting and will consider this as a potential disclosure.

The higher of two variable components

43. We note that the measurement of a ‘higher of’ promise will depend on whether it can be deconstructed into a variable and non-variable component. While the Interpretations Committee’s decision is clear regarding promises of the higher of a variable and a non-variable component, we would like to clarify the measurement for promises of the higher of two variable components.

44. If the entire promise fall within the variable component, for example because the promise for the higher of the plan assets and a return is based on a market index, then the measurement requirements above would require an entity to measure the total promise at the fair value of the reference asset. In our view, and consistent with the discussion above regarding promises of a variable return plus a margin, the reference asset would be an asset that replicates the same features as the benefit promise. In this case, those features would include the higher of the two variable components and thus would include the time value of the option. Arguably, such an approach more faithfully represents the underlying economics and addresses concerns regarding a small set of promises. However, that approach would be quite different to the measurement of a benefit that promises the higher of a variable component and a non-variable component.

Question 3

Does the Interpretations Committee have any comments on 'higher-of' plans?

Appendix A – Diagram of measurement approach benefits that promise the ‘higher-of’ a variable and non-variable component

