Research Project

Post-employment benefits

ASAF - December 2014

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Agenda

- Purpose of this session
- Summary of the plan
- Background
- Problems
- Difficulty of this project
- Scope
- Approach
- Questions for ASAF members

Purpose of this session

- Provide information about the background to a research project on post-employment benefits; and
- Ask for your comments about the scope and the approach.

Summary of the plan

- The plan of this project is discussed at the September 2014 IASB meeting.
  - ➢ For details, see Agenda Paper 8C, used in September 2014 IASB meeting.
- At this stage, we plan to publish a Research Paper during 2015:
  - ➢ to discuss what would be a sound and robust measurement model for pension plans that range from pure defined contribution (DC) to pure defined benefit (DB); and
  - ➢ to provide information about the trend among pension plans to assess costs and benefits for such a model.
- If we identify enough evidence to consider a fundamental amendment to IAS 19 we may propose to publish a Discussion Paper (DP), at a later date.
- We are assessing whether we need to have a Post-implementation Review (PIR) for the 2011 revisions to IAS 19.
  - ➢ The IASB is scheduled to have a PIR of the 2011 revisions to IAS 19 in about 2016. However, the IASB could request dispensation from our oversight body if the IASB considers that the research work is a more effective way of reviewing IAS 19.

History of this project

IASB

- There are outstanding issues beyond the scope of the 2011 revisions to IAS 19. They include accounting for contribution-based promises (CBPs) and other issues on measurement (eg attribution of benefits, discount rates).
- As a result of the Agenda Consultation 2011-2012, the IASB identified the project as a 'longer-term project' because of its complexity.

IFRS Interpretations Committee (Interpretations Committee)

- The Interpretations Committee had attempted to solve the issue on CBP.
- However, it removed this issue from its agenda in May 2014 because the problems were not solvable within IAS 19.
- In its view, developing accounting for these plans would be better addressed by a broader consideration through research by the IASB.

Long history tells us the difficulty

- Accounting for CBPs has not been solved successfully in the long history of attempts to address the issue.
  - In 2004, the Interpretations Committee issued IFRIC Draft Interpretation D9.
  - In 2006, the Interpretations Committee referred the issue to the IASB to be included in its project on post-employment benefits.
  - A proposal on the issue was included in the 2008 Discussion Paper.
  - The IASB decided to defer consideration to a future project and this issue was not addressed by the 2011 revisions to IAS 19.
  - In 2012, the Interpretations Committee received a request seeking clarification in accordance with IAS 19 (2011) and had many meetings to solve this problem.
  - However, it finally removed this issue from its agenda in May 2014.

Typical CBPs

Type of plan	Basic features	Variations	Countries
Plans with guaranteed return	• **The employee receives a benefit based on the performance of the assets.** • The employer provides a guarantee of the minimum performance of the assets in the plan (ie it is not a DC plan).	• The employer will typically guarantee a return of x% on contributions. • 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. • In some circumstances the employer may guarantee that the benefit will be no less than the contributions made, ie a return of 0%. • Usually the guarantee is given only on the employer's contributions.	Germany, Netherlands, Belgium, Switzerland, Israel (They may exist in Korea and Mexico)
Cash balance plans	• **The employee receives a guaranteed benefit based on a specified return on notional contributions.** • The plans may be funded or unfunded.	• The employer will typically guarantee a return of x% on contributions. • 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. • In some circumstances the employer might guarantee that the benefit will be no less than the contributions made, ie a return of 0%.	US, Japan, UK

(Source) Agenda Paper 5A for the September 2012 IFRS Interpretations Committee meeting

Increasing use of CBPs

- The Interpretations Committee noted the increasing use of these plans.
- The issue on CBPs has been common in Europe (eg Germany, Netherlands and Switzerland).
- Entities would like to reduce their exposure to pension risks in traditional DB plans, but it is not easy to switch to simple DC plans because of regulations or for retention of employees:
  - ‘cash balance plans’ are common in the US, Japan and the UK.
  - while most cash balance plans are not so problematic, some have similar problems to European CBPs.
  - the FASB had been considering the issues of measurement of cash balance plans including the issue of attribution of benefits to periods of service. In August 2014, the FASB decided not to undertake this project, mainly because it had not identified a technically feasible, cost-effective alternative that would narrowly address the measurement of cash balance plans.

Classification in IAS 19

- An entity classifies post-employment benefits as DC plans or DB plans in IAS 19.
- CBPs are classified as DB plans, because they do not meet the definition of a DC plan.
- In traditional DB plans, we expect actuarial risk and investment risk to fall on the entity; however, the risks of CBPs are of a different nature from traditional DB plans.
- The result of measurement in IAS 19 often becomes counterintuitive for CBPs.

Measurement in IAS 19

Measurement of DBO

- The ultimate cost of a plan is uncertain and is likely to persist over a long period.
- To measure the present value of DBO and the related service cost, an entity should
  - make assumptions including discount rates, future benefits levels, future salary increase, mortality, employee turnover etc.;
  - apply the actuarial valuation method; and
  - attribute benefits to periods of service.
- In general, an entity should use ‘high quality corporate bond’ rates as discount rates.

Measurement of plan assets

- Plan assets are measured at fair value at the end of the reporting period.

(Note) IAS 19 provide only one exception for qualifying insurance policies that exactly match the amount and timing of some or all of the benefits payable under the plan: the fair value of those insurance policies is deemed to be the present value of the related DBO.

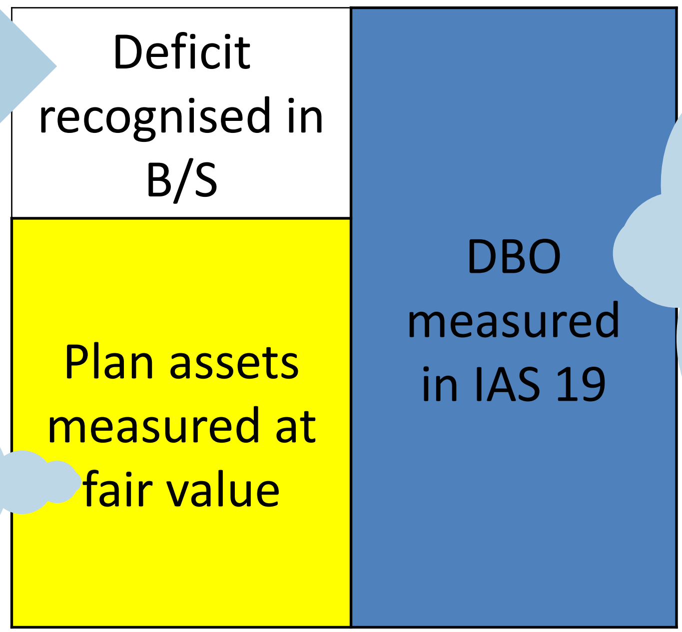
Problems

Example of a typical problem for CBPs

- To calculate the DBO for some CBPs, an entity projects the benefit to be paid on the basis of an assumption of future performance of the plan's assets. An entity often projects the benefits with a higher rate (eg 4%) than bond rates.
- The discount rate to calculate the present value of DBO is generally a high quality corporate bond rate (eg 2%) as required in IAS 19.
- The plan assets are measured at fair value as at the end of each period.
- This may result in recognising an 'excessive' deficit (ie, DBO > plan assets)

- If the assets perform less well than expected, the benefits to be paid will generally be reduced.
- **Does the amount of 'deficit' fairly reflect this nature?**

- Market prices generally reflects risks relating to future cash inflows from assets



- An entity projects future cash outflow increases by 4%, but discounts them by 2% to calculate the present value
- **No adjustment is made for risks relating to future cash flows from DBO**

Problems
Our research on discount rates implies a problem

- 'Risk premium' is not reflected either in measurement or discount rates under IAS 19.

IFRS / Project	Item measured	Measurement description	Rate description (if applicable)	Time value of money	Risk premium	Liquidity premium	Own non-performance risk
IFRS 13	Assets and liabilities at fair value	Fair value		Yes	Yes	Yes	Yes
IAS 36	Non-financial assets (impairment)	Value in use		Yes	Yes	Yes	n/a
Leases	Lease liability	Present value of future lease payments	Rate implicit in lease (Note 1)	As charged by lessor	As charged by lessor	As charged by lessor	As charged by lessor
			Incremental borrowing rate (Note 2)	Not explicit	Not explicit	Not explicit	Not explicit
Leases	Lease receivable	Net investment in lease	Rate implicit in lease (Note 1)	As charged by lessor	As charged by lessor	As charged by lessor	As charged by lessor
IFRS 9	Financial assets measured at amortised cost	Amortised cost	Effective interest rate (Note 3)	Yes	Yes	Yes	n/a
IFRS 9	Financial liabilities measured at amortised cost	Amortised cost	Effective interest rate (Note 3)	Yes	Yes	Yes	Yes
IFRS 9 [impairment]	Expected credit loss allowance [a]	Expected credit loss	Original effective interest rate (see above) or approximation thereof				
Insurance contracts	Insurance contract[b] (Note 4)	Present value of net cash flows expected to fulfil		Yes	Yes (separate)	Yes	No
IAS 37	Provisions	The amount to settle or transfer		Yes	Implicit	Not explicit	Not explicit (in practice no)
IAS 19	Defined benefit plan obligation	Present value of ultimate cost		Yes	No	Some (Note 5)	Some (Note 5)

[a] Or a provision,
[b] Liability or an asset

(Note)
1 - The rate implicit in a lease is a calculation and does not refer to individual components. It also includes the lessor's initial direct costs not mentioned in the table.
2 - The guidance about incremental borrowing rate refers to a rate that would be paid by the lessee on a similar asset, without referring to specific components.
3 - The effective interest rate is a calculation that also includes eligible fees and expenses not mentioned in the table.
4 - Includes both a cash flow component and a contractual service margin (CSM). The table does not mention the CSM.
5 – Included to the extent these are included in the rate of bonds used. The components are not entity-specific.

(Source) Agenda Paper 2 *Discount Rates: Review of existing requirements,* for September 2014 ASAF Meeting

Conceptual challenges in IAS 19

- The current model in IAS 19 has also been discussed from various conceptual viewpoints, for example:
  - Measurement basis
  - Definition of liabilities
  - Use of OCI and recycling

- Although we understand the challenges, we also note the current measurement for pension accounting has survived among many GAAPs as well as IFRS, beating any other alternatives such as VBO, ABO, settlement prices and so on.

Difficulty in changing the current model

- The current measurement has survived mainly because of its current operationality, while fair value for employee benefit liabilities is usually unavailable.
  - Comments on the 2008 DP imply a new model would not be welcomed if it would increase unjustifiable costs or if would not be operational.
- The Interpretations Committee was not able to find an appropriate scope for any exemptions from the current measurement, because any such scope inevitably involved an arbitrary bright line.
  - The bright line could cause changes to accounting for plans with few perceived problems under the current model, or fail to change accounting for plans that do have material problems.

Scope

- We think that the main scope of this research project should be:
  - to identify a conceptually desirable measurement model for pension plans that range from pure DC to pure defined benefit DB; and
  - to gather information about the trend in pension plans to assess whether and when a fundamental revision would be appropriate from viewpoint of costs and benefits.

- Measurement issues such as discount rates and the attribution of benefits among other potential issues could be included, when we consider a measurement model.

Approach

- Survey past discussions and literature to consider a possible model for all DB plans;
    - At this stage, we do not think that a ‘bright-line approach’ solves the problems fundamentally, taking account of the Interpretations Committee’s discussions.
    - We will consider models and discuss them with specialists in the early stage.
- Gather information about trends of pension plans from accounting standard-setters, actuaries, accounting firms, etc.
    - We will gather statistics to understand the trends.
    - At some point, it is likely that the balance of plans will change between traditional DB plans and new-design plans for which IAS 19 is problematic. At that time a fundamental review of IAS 19 would be appropriate.
- Prepare papers to be presented to the IASB.

Approach

- Interact with members in other projects.
  - The research on discount rates
  - Insurance project
  - Conceptual Framework project

- At this stage, we do not propose to form an advisory group, but we will have communication with the interested parties, including ASAF members (or IFASS members), users and preparers, in addition to specialists (eg actuaries).

Questions for ASAF members

- Do you have questions or comments about the project?

- Do you have any suggestions about the scope and the approach? In particular:
  - Do you have any suggestions on possible measurement models?
  - Do you have information about the trend in pension plans in your jurisdictions?