STAFF PAPER

January 2014

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		
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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 and background

1. This paper continues the Interpretation Committee's discussion of the distinction between the variable and non-variable components for employee benefit plans that fall within the Interpretations Committee's agreed scope.

2. At the September 2013 meeting, the Interpretations Committee tentatively decided that the approach based on IFRIC Draft Interpretation D9 *Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions* published in 2004 would be the most suitable for the measurement of the employee benefit plans within the agreed scope.

3. At the November 2013 Meeting, the Interpretations Committee discussed the distinction between the variable and non-variable components and requested the staff to bring a further analysis to a future meeting.

4. Further details of the previous tentative decisions of the Interpretations Committee are included in Appendix B.

5. We have also provided a sample of benefit promise designs in Appendix A to illustrate the application of the alternatives below.

The issue

6. Many consider that the projected unit credit method of recognition and measurement for defined benefit plans does not faithfully represent the economics of employee benefit plans with a promised return on actual or notion contributions. This is because the discount rate prescribed in IAS 19 does not reflect the risk of the promised return, in particular when the promised return depends on actual or notional assets (or contributions).

7. The D9 approach would require an entity to split such plans into a variable and non-variable component, with the variable component measured at fair value and the non-variable component measured using the projected unit credit method.

8. As noted in previous papers on this particular issue, the range and variety of benefit promises that fall within this project is considerable. Appendix A includes examples of such promises. Some may be more common than others, and we have not performed a detailed survey of their frequency. Agenda Paper 5A of September 2012 detailed the results of outreach that we performed to determine the types and diversity of accounting for such promises.

Staff analysis

9. Agenda Paper 2B at the November 2013 meeting included the following three alternatives to defining the variable component:

   (a) **Approach 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).

      (i) **Pros**: Scope is well defined and understood.

(ii) **Cons**: Scope may be too narrow to be helpful. Scope will result in different accounting depending on the funding status of the plan contrary to the existing principle in IAS 19.

(b) **Approach 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.

(i) **Pros**: Scope would be broader than alternative (a), and could be targeted to address concerns that were raised. Scope would be independent of whether the plan is funded or not.

(ii) **Cons**: It would be difficult to define the scope based on the characteristics of the reference assets. It could capture pension promises that are based on hypothetical assets. It would require different accounting for economically similar promises.

(c) **Approach 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 method. 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.

(i) **Pros**: Broadest scope of the alternatives, therefore likely to improve accounting for a large number of plans and ensure plans with similar economics are accounted for consistently.

(ii) **Cons**: Scope might be too broad and capture a large number of plans for which concerns *have not* been raised. Could result in

broader effects than appropriate for the Interpretations Committee's work.

10. The majority of the Interpretations Committee members expressed concern that limiting the definition of the variable component to returns based on the actual return on plan assets held (Approach A) would include only a very narrow set of promises. This approach would require many economically similar promises to be accounted for under the IAS 19 defined benefit methodology. Specifically, the Interpretations Committee was concerned that the approach would not address concerns relating to the measurement of promises based on returns on notional contributions. Thus, it would result in different accounting for the liability depending on the funding of the plan which is contrary to one of the general principles in IAS 19.

11. The majority of the Interpretations Committee members also expressed concern that extending the definition of the variable component to include **any variability** (Approach C) would include a very vast set of promises. This approach would include many promises for which the accounting under the IAS 19 defined benefit methodology is not considered troublesome.

12. Therefore, contrary to the staff recommendation, the IC expressed a preference for something within Approach B. Approach B would require the IC to define the types of assets that would qualify as suitable references for the benefit promises.

13. We have identified the following ways of implementing Approach B:

    (a) **Approach B'—Fair Value Hierarchy –** one suggestion at the last meeting was to use the fair value hierarchy from IFRS 13 *Fair Value Measurement*. This approach would classify a component of a promise as variable if the asset it refers to qualifies as a Level 1 (or potentially Level 2) asset.

    (b) **Approach B''—Equity Instruments** – this approach would classify a component of a promise as variable if the asset it refers to meets the

definition of an equity instrument in IAS 32 *Financial Instruments: Presentation*[1].

14. The approaches above are not mutually exclusive or exhaustive, therefore it might be possible to combine aspects depending on the Interpretation Committee's preferences.

15. We also considered a 'hedging' approach that modifies Approach A to include cases where the plan assets (and potentially the assets held by the entity) match the assets referred to by a component of the promise. This modification could alleviate the anomaly identified in the previous meeting where a promise does not reference the plan assets, however the plan assets are the same assets as referenced by the promise. However we rejected the approach because of the inherent complexity that a hedging approach would introduce.

Fair Value Hierarchy approach

16. IFRS 13 uses the fair value hierarchy to prioritise information and categorise fair value measurements. Under IFRS 13, an entity is required to maximise its use of observable market information and minimise its use of other measurement techniques. The entity is also required to disaggregate its fair value measurements between the three levels and to show movement between the levels from year to year.

17. This approach would classify a component of a promise as 'variable' if that component referred to the return of an asset that meets the Level 1 (or potentially Level 2) definition of the fair value hierarchy in IFRS 13. Thus, the variable component would be determined based on the liquidity of the underlying asset's market and how observable the price of the asset is.

18. The advantages of this approach would be that the measurement of the variable component should be relatively easy (especially if limited to Level 1), and that it would apply to funded and unfunded plans equally. This approach might also

[1] Note the reference to equity instrument here is not to the entity's own equity instruments

avoid including benefits that reference 'exotic' assets within the variable component.

19. A disadvantage of this approach would be that promises with similar economics would be treated differently simply because of the market characteristics of the reference asset. This would lead to a decrease in comparability.

20. Another disadvantage of this approach would be that the existence of a market might be volatile, or within the ability of a market maker to create a market. Thus, this approach would require the IC to develop requirements to deal with changes in the fair value hierarchy of the reference asset. Such requirements might include reclassification rules similar to IFRS 9, or perhaps prohibition of reclassification. Reclassification would lead to anomalies, for example changes in the basis of measurement that have not resulted from changes in the underlying promise, but simply from changes in the market for the reference assets. Prohibiting reclassification would result in different measures of identical obligations depending on whether there was an observable price at the time the promise is made. Thus prohibiting reclassification would decrease comparability between entities, however it would improve comparability over time for a single entity compared to permitting reclassification.

Equity Instrument approach

21. The equity instrument approach would classify a component of a promise as 'variable' if that component referred to the return of an asset that meets the definition of an equity instrument in IAS 32 or an index of such instruments. That definition is already used in IFRS 9 *Financial Instruments* to allow entities to elect to recognise gains and losses on an investment in an equity instrument in other comprehensive income.

22. In contrast with the Fair Value Hierarchy approach, this approach would not be reliant on the existence of a market in the reference assets. In addition, given that equities are typically riskier than bonds, such an approach would be targeting promises for which the existing IAS 19 approach is most distorting of the underlying economics of the obligation.

23. However, the disadvantages of this approach would be that it would only apply to a very narrow class of assets. Thus, promises with returns based on any other types of assets, such as bonds, inflation and wage index linked instruments, or any other derivatives (including compound instruments and promises of a fixed margin above or below a given asset return) would fall into the non-variable category.

Staff recommendation

24. Based on the above, the staff recommends that the Interpretations Committee defines the variable component using a combination of Approach A and Approach B''. Thus the variable component would be a promise that would reference:

    (a) a return on the actual plan assets; or

    (b) a return on an equity instrument.

25. The recommended approach would capture a significant number of the troublesome plans (Promises 6, 7 and 7A in Appendix A). Of course, such an approach would exclude promises that refer to assets that are not plan assets or equity instruments, such as bonds, price indices and other derivatives (including compound instruments and promises of a fixed margin above or below a given asset return). Extending the definition of the variable component to include promises that reference assets in Level 1 or Level 2 of the fair value hierarchy might include some of these types of promises. However, in the staff's view, the cost of the additional complications of a fair value hierarchy based approach would not outweigh the benefits. Therefore, promises that refer to returns on assets that are not plan assets or equity instruments would be measured using the existing defined benefit methodology.

Question

Does the Interpretations Committee agree with the staff recommendation to define the 'variable' component of promises that fall within the agreed scope of the Interpretations Committee's work as:

A promise of a return on the actual return on plan assets; or

A promise of a return on actual or notional contributions based on specified equity instruments (as defined in IAS 32) or a specified index of such instruments.

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

Description of promises	Alternative A Variable component is actual return on plan assets held	Alternative C Variable component is any promised return that includes market reference	Alternative B' Variable component is promise with return on asset in Level 1 (or Level 2)	Alternative B'' Variable component is promise with return on equity
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	Defined contribution	Defined contribution
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	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	Defined benefit	Defined benefit	Defined benefit	Defined benefit

in the most recent (ie final) three years of service.				
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. 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.	Defined benefit	Defined benefit	Defined benefit	Defined benefit
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	Defined benefit	Defined benefit
4 Fixed return of 3% The same as **Promise 3** but with a 3% fixed return on contributions per year.	Defined benefit	Defined benefit	Defined benefit	Defined benefit
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	Defined benefit	Defined benefit
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	Fair value of reference assets	Fair value of reference assets
Combinations				
7 Higher of The employer promises to make contributions of 5 per cent of the employee's salary during the	Higher of variable (fair value of plan assets) and non-variable	Higher of variable (fair value of replicating assets) and	Depends if plan assets are Level 1 (or Level 2)	Defined benefit

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**.	components (defined benefit)	non-variable components (defined benefit)		
7A – Alternative – The benefit promise at retirement is a lump sum equal to the (notional) contributions increased with the compound return on a specified equity index **or** 3 per cent, **whichever is higher**.	Defined benefit	Higher of variable (fair value of replicating assets) and non-variable components (defined benefit)	Higher of fair value of reference assets and return of 3 per cent	Higher of fair value of reference assets and return of 3 per cent
8 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 2A**) 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	Defined benefit
9 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	Defined benefit	Defined benefit

Appendix B—Previous discussions

Scope

26. In September 2012 and November 2013, the Interpretations Committee tentatively decided that employee benefit plans should fall within the scope of its work if they have the following characteristics:

    (a) the plans would be classified as defined contribution plans under IAS 19 *Employee Benefits* (or would be defined contribution plans if they were funded by actual rather than notional contributions) if not for the guarantee provided by the employer on the return of the contributions made;

    (b) the contributions made to the plans can be notional contributions (ie whether the plans are funded or not should not affect the basis of accounting for these plans);

    (c) there should be a guarantee of return by the employer on the contributions (notional contributions) made;

    (d) the benefit under the plans should not be dependent on salary risk; and

    (e) the guarantee under the plan may be based on the value of one or more underlying assets.

27. The Interpretations Committee also tentatively decided that an employee post-employment benefit plan, or other employee long-term benefits, would fall within the scope of the Draft Interpretation if the employer has a legal or constructive obligation to pay further contributions, and the fund does not hold sufficient assets to cover all employee benefits relating to employee service in the current and prior periods in respect of:

    (a) a promised return on contributions, actual or notional; or

    (b) any other guarantee on contributions, actual or notional, based on the value of one or more underlying assets.

28. In July 2013, the Interpretations Committee observed that the agreed scope might be broader than it had envisaged because promises such as some current salary

and career average promises would be included. However, in the light of the ongoing concerns about how to account for employee benefit plans with a guaranteed return on contributions or notional contributions, and the resulting diversity in practice, the Interpretations Committee tentatively decided to proceed with this project on the basis of the agreed scope

Recognition and Measurement

29. In November 2012, the Interpretations Committee discussed how to address the measurement of the so-called 'higher of' option. The higher-of option relates to when the employee is guaranteed the higher of two or more possible outcomes. For example, the employer may promise the employee the higher of a fixed return of four per cent and the actual return on the contributions.

30. The Interpretations Committee tentatively decided that an entity should measure the higher-of option at its intrinsic value at the reporting date. It also considered the accounting and presentation for the higher-of option but did not make a decision on the issue.

31. In November 2013, the Interpretations Committee tentatively decided that the defined benefit methodology set out in IAS 19 should be applied to the non-variable component and that for the variable component:

    (a) the plan liability should be determined by the fair value of the underlying reference assets at the reporting date;

    (b) if a benefit is unvested at the reporting date, the measurement of the plan liability shall be determined by the extent to which the benefit is expected to vest in the future;

    (c) the measurement of the variable component should not consider the entity's credit risk, and therefore it should be measured based on the fair value of the underlying assets without adjustment; and

    (d) the variable component of a benefit promise is allocated to periods of service in line with the benefit formula.