STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**Annual Improvements to IFRSs 2012-2014 Cycle (ED/2013/11)—Comment letter analysis**
Paper topic	IAS 19 *Employee Benefits*–Discount rate: regional market issue

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Introduction

1. The Exposure Draft ED/2013/11 *Annual Improvements to IFRSs 2012–2014 Cycle* published in December 2013 (the ED) includes a proposal for an amendment to IAS 19 *Employee Benefits* to clarify that:

   (a) the high quality corporate bonds ('HQCB') used to estimate the discount rate for post-employment benefit obligations should be denominated in the same currency as the liability; and

   (b) the depth of the market for HQCB should be assessed at the currency level.

Objective

2. The objective of this paper is to provide an analysis of the comment letters received on the proposal to amend IAS 19 and to obtain a recommendation from the IFRS Interpretations Committee (the Interpretations Committee) for the IASB to include the amendment in the final *Annual Improvements to IFRSs 2012-2014 Cycle* that is planned to be published later in 2014.

Structure of the paper

3. This paper:

   (a) provides a description of the issue that led to the proposed amendment;

   (b) analyses the comments received as part of the Exposure Draft process; and

   (c) asks the Interpretations Committee to confirm whether it agrees with the staff recommendation.

Description of the issue

4. The Interpretations Committee was asked to clarify the requirements of IAS 19 to determine the discount rate in a regional market consisting of multiple countries sharing the same currency (eg the Eurozone).

5. The issue arose because paragraph 83 of IAS 19 states that **in countries** where there is no deep market in HQCB, the market yields (at the end of the reporting period) on government bonds shall be used. In other words, IAS 19 requires an entity to identify a market for corporate bonds, and assess whether that market is a deep market, in order to decide whether it should use a HQCB yield or a government bond yield as its discount rate. Consequently, the issue is, when making the assessment of market depth, whether an entity should look at:

   (a) the market for corporate bonds within its country; or

   (b) the market for corporate bonds within the same currency.

Comment letter analysis

6. In this section, we discuss and analyse the main comments received from interested parties on the ED during the comment period, which ended on 13 March 2014.

7. The ED asked two general questions that were answered individually for each proposed amendment:

(a) *Question 1: Do you agree with the IASB's proposal to amend the Standard as described in the Exposure Draft? If not, why and what alternative do you propose?*

(b) *Question 2: Do you agree with the proposed transitional provisions and effective date for the issue as described in the Exposure Draft? If not, why and what alternative do you propose?*

8. The IASB received 64 comment letters on the ED in total; 58 respondents expressed their views on the proposed amendment to IAS 19.

Analysis of Question 1

9. The majority of the respondents conditionally agree with the proposal. However, many respondents have concerns about the proposed amendment.

10. The main themes contained in the comments received are as follows:

(a) The proposed amendment is not precise enough to avoid diversity in practice. A concern arises from different views regarding the origin of the HQCB used. According to one view, all worldwide available HQCB, denominated in the same currency as the post-employment benefit obligation, have to be considered when determining the discount rate (eg in determining the discount rate for a post-employment benefit obligation denominated in Euros, all HQCB available worldwide denominated in Euros are to be considered). According to a different view, if there is a deep market for HQCB in one country (e.g. Germany), only HQCB from that country's entities have to be considered in determining the discount rate. If there is no deep market on the country level, one shall consider HQCB from other countries or a region (e.g. Eurozone)[1].

(b) It is not clear whether the understanding of this 'currency' principle would apply similarly to government bonds (eg if there were no deep market for any HQCB in Euros, hence, the discount rate is to be

[1] See, for example, comment letter of Accounting Standards Committee of Germany.

determined by market yields on government bonds 'denominated in that currency', should an entity consider government bonds denominated in Euros in its own country, or in any other country of the Eurozone, or even in any country in the world?)[2].

(c) It is not clear whether the government bonds used to determine the discount rate should be of high quality[3].

(d) The IASB should clarify the objectives and the rationale underlying the selection and use of the discount rate, before finalising the amendment. The IASB should undertake a thorough analysis of the effects of its proposal, because the amendments could result in anomalous outcomes when a jurisdiction adopts a stronger currency (e.g. US Dollar) for general commercial purposes even if the economic fundamentals of these two jurisdictions are not comparable (e.g. the Republic of Ecuador that uses the US Dollar as its currency). The use of a discount rate based on bonds issued by entities domiciled in another country that uses the same currency but whose economic fundamentals are different might be incompatible with other required inputs such as inflation or might lead to uncertainty as to which inflation rate to apply (e.g. domestic, regional or foreign). Paragraph 78 of IAS 19 requires entities to apply mutually compatible assumptions in relation to inflation and discount rates. Therefore, before finalising the amendment the IASB should carry out some further analysis to ensure there are no unintended consequences and to ensure there is common understanding of mutually compatible inflation, discount rates and other assumptions where the discount rate is derived from a bond issued in a foreign currency[4].

(e) It would be useful to amend IAS 19 in order to clarify that the depth of the market for high quality corporate bonds may be assessed at the currency level when facts and circumstances indicate that the entity is

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[2] See, for example, comment letter of Accounting Standards Committee of Germany.

[3] See, for example, comment letter of Alliance.

[4] See, for example, comment letter of EFRAG.

operating in a country where a high-quality corporate bond market does not exist; otherwise an assessment at country level may be more appropriate[5].

(f) It should be clear that eg for the Eurozone an entity is not required, but is allowed, to include Euro HQCB from issuers outside the Eurozone, provided that a deep market in the respective currency zone for HQCB exists[6].

(g) The IASB should address that issue comprehensively, instead of 'quick-fixing' the Standard, leaving the underlying conceptual issue unaddressed[7].

(h) The draft amendment does not address the impact of pegged exchange rates and there are different views on the implications[8].

11. We have grouped the concerns above into the issues below:

(a) countries/Regional markets where there is a deep market for HQCB;

(b) countries that adopt a stronger currency;

(c) countries with exchange rates pegged to a stronger currency;

(d) government bonds; and

(e) clarify the objective.

12. We analyse the concerns that we identified above in the following paragraphs.

Countries/regional markets where there is a deep market for HQCB

13. The issue is whether the proposed amendment prohibits an entity that operates in a country/regional market where there is a deep market for HQCB (eg Germany/Eurozone) from using only the HQCB issued in its own country.

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[5] See, for example, comment letter of Repsol.

[6] See, for example, comment letter of BusinessEurope.

[7] See, for example, comment letter of BusinessEurope.

[8] See, for example, comment letter of PWC.

14. We think that the objective of the proposed amendment is to clarify the requirements regarding the market that an entity should look at when assessing whether it should use a HQCB yield or a government bond yield as the discount rate. We do not think that the objective of the amendment is to clarify how the discount rate should be derived once an entity has made that assessment. That is, an entity need not undertake an exhaustive search to include all HQCBs issued in a given currency when deriving the discount rate. IAS 19 does not specify the method that an entity should use to determine its basket of HQCB and the intention of the proposed amendment is not to provide guidance on this matter. The proposed amendment only says that the depth of the market for HQCB should be assessed at a currency level (and not a country/regional market level). It does not say that the basket of HQCB shall include all the HQCB issued in a currency.

15. The Exposure Draft proposed to delete the word 'countries' from paragraph 83 of IAS 19, because the reference to 'countries' has been interpreted, by some, to require that the depth of the market for HQCB should be determined at a country level. In our view, the intention of the amendment is only to clarify the existing requirement of paragraph 83 of IAS 19, that is: …*The currency and term of the corporate bonds or government bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations*.

16. In our view, the proposed amendment is consistent with the agenda decision issued by the Interpretations Committee in in June 2005, which states: "*The IFRIC observed that the reference to 'in a country' could reasonably be read as including high quality corporate bonds that are available in a regional market to which the entity has access, provided that the currency of the regional market and the country were the same (eg the euro). This would not apply if the country currency differed from that of the regional market*"

Countries that adopt a stronger currency

17. Some respondents have concerns about the potential effects of the proposed amendment on:

    (a) countries that have adopted a stronger currency as their official or legal currency (eg Panama, El Salvador and Ecuador have adopted USD) without being members of a regional market or part of one with a common currency; and

(b) entities that denominate defined benefit obligations in a stronger currency (eg Zimbabwean entities usually denominate employee payments in USD).

18. They think that the proposed amendment could result in anomalous outcomes in these countries, because a discount rate determined from HQCB denominated in a strong currency (eg USD) could be inconsistent with the inflation rate (and the other assumptions) used in these countries to determine the cost of providing post-employment benefits. They note that according to paragraph 75 of IAS 19 actuarial assumptions shall be mutually compatible. They also note that paragraph 78 of IAS 19 states: *Actuarial assumptions are mutually compatible if they reflect the economic relationships between factors such as inflation, rates of salary increase and discount rates. For example, all assumptions that depend on a particular inflation level (such as assumptions about interest rates and salary and benefit increases) in any given future period assume the same inflation level in that period.*

19. We agree that the inflation rate in, for example, Ecuador (3.1% in March 2014[9]) is different from the inflation rate in the US (1.5% March 2014[10]). However, we note that there is the same issue in the Eurozone; for example the inflation rate in Greece (-0.9% in 2013[11]) is different from the inflation rate in Germany (1.6% in 2013[12]). Indeed, in any geographical comparison inflation rates in one location will be different to those in another, even if they are in the same country or state (eg inflation rates in San Francisco will be different to those in Los Angeles[13]).

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[9] Source: http://www.tradingeconomics.com/ecuador/inflation-cpi

[10] Source: http://www.tradingeconomics.com/united-states/inflation-cpi

[11] Source: http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tec00118

[12] Source: http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tec00118

[13] Source: http://www.bls.gov/regions/cpi.asp

20. Consequently, in our view, the fact that these countries have inflation rates different from the inflation rate in the US does not necessarily mean that the actuarial assumptions are not compatible. However, we agree that entities operating in these countries should carefully consider whether a discount rate determined using HQCB issued in the US is compatible with the other assumptions. We note that paragraph 79 of IAS 19 already provides some guidance, it states that: *An entity determines the discount rate and other financial assumptions in nominal (stated) terms, unless estimates in real (inflation-adjusted) terms are more reliable, for example, in a hyperinflationary economy…*

21. We agree with the concerns about the potential effects of this proposed amendment in some of these countries. If, for example, in these countries the depth of the market for HQCB is currently assessed at a country level, then the proposed amendment might result in using discount rates significantly lower than the rates currently used.

22. At the moment, on the basis of the comments received, we are not able to provide an effect analysis of the proposed amendment (eg number of entities affected, magnitude of post-employment benefit obligations, etc.).

23. In the light of the comments received, we think that an analysis of the potential effects of the proposed amendment in these countries is necessary, even though we usually do not perform an effect analysis for annual improvements and narrow scope amendments.

Countries with exchange rates pegged to a stronger currency

24. Some respondents asked the IASB to clarify whether the proposed amendments also apply when a currency is pegged to another currency.

25. We think that according to the proposed amendment the depth of the market for HQCB should be assessed at a currency level and that currency is only the currency in which the benefits are to be paid. In our view, a pegged currency is another currency that should continue to be viewed as separate from the currency to which it is pegged.

Government bonds

26. Some respondents requested to clarify which government bonds should be used if the market for HQCB is not deep. For example, if the market for HQCB denominated in Euros was not deep, it is not clear whether an entity should use the government bonds denominated in Euros issued in its own country, or in any other country of the Eurozone, or even in any country in the world.

27. Other respondents asked the IASB to clarify whether the government bonds used to determine the discount rated should be of high quality.

28. We think that the scope of the proposed amendment should not be increased; the Interpretations Committee has already discussed a potential broader amendment relating to the discount rate and did not reach a consensus.

29. We think that the proposed amendment should not specify which government bonds should be used. We note that, in our view, the proposed amendment does not specify which HQCB should be used to determine the discount rate (ie only HQCB issued in the country, or in the regional market or anywhere in the world).

Clarify the objective

30. Some respondents think that the IASB should clarify the objectives and the rationale underlying the selection and use of the discount rate for post-employment benefit obligations.

31. Other respondents think that the IASB should address this issue comprehensively, by addressing the conceptual issue.

32. Other respondents think that the IASB should remove this issue from the annual improvements project and include it in its research project agenda.

33. We understand these comments, and we note that in November 2013 the Interpretations Committee recommended that the determination of the discount rate for post-employment benefit obligations should be addressed in the IASB's research project on discount rates.

Analysis of Question 2

34. The majority of the respondents agree (or conditionally agree) with the proposed transitional provision (ie retrospective application in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*).

35. We report below the main comments received on the proposed transitional provision:

(a) With regard to the proposed transitional provision, although we suspect that for many entities it would not be unduly burdensome to apply the proposed changes retrospectively, we believe that some entities may face significant complexity in their application.

For example, consider entities that are required by local law or regulations to accumulate components of the benefit plan separately for distributable profit purposes (e.g. remeasurements separately from other income statement items) and that operate in a particular country where there is not a local deep market in high-quality corporate bonds of the appropriate currency, but such a market exists elsewhere. In such cases, we are concerned about the practicability of a full retrospective application of the amendments, because under the proposals such entities would need to recalculate all of the IAS 19 elements that have been recognised before the start of the comparative period by applying the relevant high-quality corporate bond rate for each period that has passed.

For these entities, retrospective application of the proposed changes would be overly complex and, as such, we suggest that the Board consider providing an appropriate transitional relief; for example, require the application of the different discount rate from the beginning of the earliest comparative period presented in the year the revision is adopted[14].

(b) We however do not support the retrospective application. We suggest to apply the improvements prospectively, as the nature of the change is more a change in estimate and the transition would be similar to the transition guidance of IFRS 13[15].

[14] See comment letter of KPMG.

[15] See comment letter of DASB.

(c) The transitional arrangements require retrospective application which is onerous as in most cases the obligation is likely to increase and therefore three reporting periods of data will need to be collated. We believe the board should perform further research into the impact of the proposed amendment which should be subject to the IASB's full due process[16].

36. Even though we think that the proposed amendment in most cases is only a clarification, we agree that for some entities a full retrospective application of the proposal can be burdensome. Consequently, we propose that the amendment should be applied prospectively from the beginning of the earliest comparative period presented in the first financial statements in which the entity applies the amendment.

Staff recommendation

37. We recommend that the Interpretations Committee should wait for the analysis of the potential effects of the proposed amendment to IAS 19 before recommending whether the IASB should proceed with the proposed amendment.

38. We also recommend that the effect analysis should be limited to:

(a) countries that have adopted a stronger currency as their official or legal currency (eg Panama, El Salvador and Ecuador have adopted USD) without being members of a regional market or part of one with a common currency; and

(b) entities that denominate defined benefit obligations in a stronger currency than the currency in the country they operate in (eg Zimbabwe).

39. In our view, the effect analysis should consist of the following steps:

(a) ask the respondents that raised this concern for more detailed information about the current practice in these countries (ie how entities determine the discount rate, inflation rates used, etc…); and

[16] See comment letter of Moore Stephens.

(b) ask GLASS[17] (and other interested parties, such as employee benefits experts) whether they can help us in estimating:

(i) the number of entities that account for defined benefit plans in accordance with IAS 19, and

(ii) whether post-employment defined benefit obligations are material for those entities.

40. If the Interpretations Committee decides to recommend to the IASB to finalise the proposed amendment, we think that the Interpretations Committee should recommend that the amendment should be applied prospectively from the beginning of the earliest comparative period presented in the first financial statements in which the entity applies the amendment.

Questions to the IFRS Interpretations Committee

1 Does the Interpretations Committee agree that it should wait for the analysis of the potential effects of the proposed amendment to IAS 19 for the countries identified above before recommending whether the IASB should proceed with the amendment?

2 Does the Interpretations Committee agree with the recommended effect analysis summarised in paragraphs 38 and 39 of this paper? Does the Interpretations Committee any comments or suggestions on this analysis?

3 Does the Interpretations Committee agree that the amendment should be applied prospectively from the beginning of the earliest comparative period presented in the first financial statements in which the entity applies the amendment?

[17] Group of Latin American Standard Setters.