

## STAFF PAPER

March 2017

## IFRS Interpretations Committee Meeting

Project	New items for initial consideration		
Paper topic	IAS 19 <i>Employee Benefits</i> —Discount rate		
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This paper has been prepared for discussion at a public meeting of the IFRS Interpretations Committee (the Committee). Comments on the application of IFRS Standards do not purport to set out acceptable or unacceptable application of IFRS Standards—only the Committee or the International Accounting Standards Board (the Board) can make such a determination. Decisions made by the Committee are reported in IFRIC<sup>®</sup> *Update*. The approval of a final Interpretation by the Board is reported in IASB<sup>®</sup> *Update*.

## Introduction

1. The IFRS Interpretations Committee (the Committee) received a request to clarify how an entity determines the rate to use to discount post-employment benefit obligations (discount rate). The entity operates in a country (ie Ecuador) that has adopted another currency (ie US dollar) as its official or legal currency without being part of a regional market.
2. The objective of this paper is to:
  - (a) provide the Committee with a summary of the issue and the staff's analysis; and
  - (b) ask the Committee whether it agrees with the staff recommendation not to add this issue to its agenda.

## Structure of the paper

3. This paper includes:
  - (a) background information;
  - (b) staff analysis; and
  - (c) staff recommendation.

4. There are four appendices to this paper:
  - (a) Appendix A—proposed wording of the tentative agenda decision;
  - (b) Appendix B—paragraphs BC129-BC139 of IAS 19 (reproduced for ease of reference); and
  - (c) Appendix C—comparison of inflation rates; and
  - (d) Appendix D—submission.

### **Background information**

5. Paragraph 83 of IAS 19 *Employee Benefits* specifies the methodology an entity applies when it determines the discount rate (ie discount rate methodology). This paragraph states:

The rate used to discount post-employment benefit obligations (both funded and unfunded) shall be determined by reference to market yields at the end of the reporting period on high quality corporate bonds. For currencies for which there is no deep market in such high quality corporate bonds, the market yields (at the end of the reporting period) on government bonds denominated in that currency shall be used. 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.

### ***Use of market yields on high quality corporate bonds***

6. The submitter says there is no deep market in Ecuador for US dollar denominated high quality corporate bonds (HQCB). The submitter questions whether, in that situation, an entity in Ecuador that has US dollar denominated post-employment benefit obligations (pension obligations) considers US dollar denominated HQCB in other markets or countries in which those bonds are issued (for example, the United States of America (US)).

7. Some say the discount rate methodology requires the entity to evaluate whether there is a deep market in HQCB at the level of the currency in which the pension obligation is denominated, and not at the country level. Accordingly, when making this assessment, an entity considers other markets in which HQCB denominated in that currency are issued. If there is a deep market in HQCB denominated in that currency, the entity determines the discount rate by reference to market yields on HQCB. This is the case even if that deep market is in a market or country that is different from the market or country in which the entity operates.
8. However, the submitter says it is not appropriate for the entity to consider US dollar denominated HQCB from other markets or countries. This is because, in the submitter's view, a discount rate derived from US dollar denominated HQCB in another market (such as the US) would be inconsistent with other actuarial assumptions based on Ecuadorian economic factors—and thus would not meet the requirements of paragraph 75 of IAS 19, which states that 'actuarial assumptions shall be unbiased and mutually compatible.' In particular, the submitter says:
- (a) the use of a discount rate derived from market yields on US dollar denominated HQCB in the US would not reflect the economic reality of entities operating in Ecuador. The market in the US is significantly different from the market in Ecuador. The two markets do not share similar macroeconomic variables as would generally be the case in a regional market, such as the Eurozone.
  - (b) it is not appropriate to discount the cash flows of a pension obligation in a country that does not have a deep market in HQCB with a discount rate derived from HQCB in a country that has a deep market in HQCB. This is because the entity generally funds the cash flows with local financial assets and financing from local entities.
  - (c) when assessing impairment, IAS 36 *Impairment of Assets* requires an entity to use a discount rate that reflects current market assessments of: (i) the time value of money; and (ii) the risks specific to the asset for which the entity has not adjusted the future cash flow estimates. The submitter says, similarly, when measuring pension obligations, an entity should use a discount rate that considers the financial performance of its plan assets.

- (d) using a rate derived from market yields on US dollar denominated HQCB in another market or country would result in a loss of comparability with other entities in neighbouring countries, which share similar economic characteristics but do not use the same currency.

### ***Use of market yield on government bonds***

9. The submitter says if entities cannot derive a discount rate by reference to market yields on HQCB, paragraph 83 of IAS 19 requires an entity to use the market yield on government bonds denominated in the currency of its pension obligations. If the entity described in the submission is required to use market yields on US dollar denominated government bonds, the submitter asks whether the entity can use market yields on US dollar denominated bonds issued by the Ecuadorian government or, instead, is required to use market yields on US dollar denominated bonds issued by the US government. For reasons similar to those outlined in paragraph 8 above (ie consistency of actuarial assumptions, etc), the submitter says that the entity should use market yields on US dollar denominated bonds issued by the Ecuadorian government. However, some say the entity should use market yields on US dollar denominated bonds issued by the US government.

### **Staff analysis**

10. The discount rate methodology (specified in paragraph 83 of IAS 19) outlines how entities determine the discount rate. Paragraph 75 of IAS 19 requires actuarial assumptions to be unbiased and mutually compatible.
11. In the following paragraphs, we have first assessed how the entity described in the submission applies the discount rate methodology. We then assess whether the application of this methodology could conflict with the requirements in paragraph 75 of IAS 19 for actuarial assumptions to be mutually compatible.

### ***Applying the discount rate methodology***

12. Paragraph 83 of IAS 19 was amended as part of *Annual Improvements to IFRSs 2012-2014 Cycle*. The changes made to paragraph 83 of IAS 19 were as follows (deleted text is struck through and new text is underlined):

The rate used to discount post-employment benefit obligations (both funded and unfunded) shall be determined by reference to market yields at the end of the reporting period on high quality corporate bonds. ~~In For countries currencies where for~~ which there is no deep market in such high quality corporate bonds, the market yields (at the end of the reporting period) on government bonds denominated in that currency shall be used. 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.

13. This amendment was effective for annual periods beginning on or after 1 January 2016.

#### *Assessing the depth of the market in HQCB*

14. Following the amendment, the discount rate methodology requires an entity to assess the depth of the market in HQCB at a currency level, and not a country level. Accordingly, if an entity has a pension obligation denominated in US dollars, paragraph 83 of IAS 19 requires the entity to assess the depth of the market in HQCB denominated in US dollars.
15. Paragraph BC150A of IAS 19 states that the amendment was made in response to a question on how an entity determines the discount rate in a regional market sharing the same currency (such as the Eurozone). Nonetheless, paragraph 83 does not differentiate between entities operating in countries that are part of a regional market and entities operating in countries which have adopted another country's currency as their official or legal currency. Accordingly, the requirement to assess the depth of the market in HQCB at a currency level applies regardless of whether an entity operates in, for example, the Eurozone or in Ecuador. This assessment is not conditional on whether the economic or other characteristics of another market that

issues HQCB denominated in that particular currency are similar to those of the market in which the entity operates.

16. The Board’s rationale in making this amendment was to ensure that the discount rate an entity applies to its pension obligations reflects the currency in which those pension obligations are denominated. This is stated in paragraphs BC150B and BC150C of IAS 19:

BC150B The Board noted that paragraph 83 of IAS 19 states that 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.

BC150C The Board decided to amend paragraph 83 of IAS 19 in order to clarify that the depth of the market for high quality corporate bonds should be assessed at a currency level.

17. Accordingly, an entity in Ecuador that has US dollar denominated pension obligations assesses the depth of the market in US dollar denominated HQCB. We think that in making this assessment, the entity also considers markets other than its own in which US dollar denominated HQCB are issued (such as the US). If, for example, there is no deep market in US dollar denominated HQCB in Ecuador, but there is a deep market in US dollar denominated HQCB in the US, then paragraph 83 of IAS 19 requires the entity to determine the discount rate by reference to market yields on HQCB. The entity cannot determine the discount rate by using market yields on government bonds if there is a deep market in US dollar denominated HQCB.

18. When the Board proposed amending paragraph 83 of IAS 19 to require entities to make this assessment at a currency level (and thus remove the reference to ‘countries’), some respondents expressed concerns about the potential effects of the proposed amendment on countries like Ecuador that have adopted another country’s currency as their official or legal currency. The Board explicitly considered these concerns when finalising the proposed amendments. Paragraph BC150F of IAS 19 states:

Some respondents to the 2013 Annual Improvements Exposure Draft expressed concerns about the potential effects of the amendment on countries that have adopted a currency

as their official or legal currency without being members of a regional market or part of one with a common currency. They think that the proposed amendment could result in anomalous outcomes in these countries, because a discount rate determined from high quality corporate bonds denominated in a stronger currency could be inconsistent with the inflation rate (and the other assumptions) used in these countries to determine the cost of providing post-employment benefits. The Board noted that this anomaly is not unique to the fact pattern raised. Instead, inflation rates in one location may be different to those in another, even if they are in the same country, state or regional market with a shared currency...

*The population of HQCB to reference when determining the discount rate*

19. The discount rate methodology does not specify the population of HQCB that an entity references when it determines the discount rate. It requires that the currency and the term of the HQCB bonds referenced are consistent with the currency and estimated term of the pension obligations, but does not say anything further about the population of HQCB to reference. An entity therefore applies judgement in determining the appropriate population of HQCB to reference when determining the discount rate. An [agenda decision](#) issued by the Committee in November 2013 notes:

...typically the identification of the HQCB population used as a basis to determine the discount rate requires the use of judgement...

20. When the Board amended paragraph 83 of IAS 19 in 2014, it noted the following in paragraph BC150E of IAS 19:

...the amendment only clarifies that the depth of the market for high quality corporate bonds should be assessed at a currency level and not a country/regional market level. It does not require that the basket of high quality corporate bonds used to determine the discount rate for post-employment obligations must include all the high quality corporate bonds issued in a currency.

21. The Committee also observed that corporate bonds must be of high quality. The [agenda decision](#) issued by the Committee in November 2013 states:

...The Interpretations Committee further noted that ‘high quality’ as used in paragraph 83 of IAS 19 reflects an absolute concept of credit quality and not a concept of credit quality that is relative to a given population of corporate bonds, which would be the case, for example, if the paragraph used the term ‘the highest quality’. Consequently, the Interpretations Committee observed that the concept of high quality should not change over time. Accordingly, a reduction in the number of HQCB should not result in a change to the concept of high quality. The Interpretations Committee does not expect that an entity’s methods and techniques used for determining the discount rate so as to reflect the yields on HQCB will change significantly from period to period...

*Use of market yields on government bonds*

22. If there is no deep market in HQCB denominated in the currency of the entity’s pension obligations, the discount rate methodology requires the entity to use market yields on government bonds denominated in that currency to determine the discount rate.
23. Similarly as for HQCB, the discount rate methodology does not specify the population of government bonds that an entity uses to determine the discount rate. It requires only that the currency and term of the government bonds be consistent with the currency and estimated term of the pension obligations. An entity applies judgement in determining the appropriate population of government bonds to use when determining the appropriate discount rate.
24. In 2013, the Committee considered issuing additional guidance on, or changing, the discount rate methodology. As part of this, the Committee specifically discussed clarifying which government bonds an entity uses when determining the discount rate (see ‘Interpretations Committee’s work in progress’ section from [IFRIC Update](#) May 2013). However, as noted in July 2013 [IFRIC Update](#), the Committee concluded that



‘issuing additional guidance on or changing the requirements for the determination of the discount rate would be too broad for it to address in an efficient manner.’

*Conclusion on applying paragraph 83 of IAS 19*

25. On the basis of our analysis of the discount rate methodology, we think:
- (a) an entity with pension obligations assesses the depth of the market in HQCB denominated in the currency of its pension obligation (in this case, the US dollar). The entity does not limit this assessment to the market or country in which it operates (in this case, Ecuador), but also considers other markets or countries in which US dollar denominated HQCB are issued.
  - (b) if there is a deep market in US dollar denominated HQCB, the entity determines the discount rate by reference to market yields at the end of the reporting period on such bonds. This is the case even if there is no deep market in such bonds. In this situation, the entity does not use market yields on government bonds to determine the discount rate.
  - (c) if there is no deep market in US dollar denominated HQCB, the entity determines the discount rate using market yields on US dollar denominated government bonds.
  - (d) the entity applies judgement to determine the appropriate population of HQCB or government bonds to reference when determining the discount rate. The currency and term of the bonds must be consistent with the currency and estimated term of the pension obligations.

**Question 1 for the Committee**

Does the Committee agree with the staff’s conclusion in paragraph 25 of this paper on how, in the fact pattern in the submission, an entity applies the requirements in paragraph 83 of IAS 19?

***Could applying the discount rate methodology lead to the actuarial assumptions not being mutually compatible?***

26. Paragraph 75 of IAS 19 states:

Actuarial assumptions shall be unbiased and mutually compatible.

27. 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.

28. The submitter says if entities in Ecuador determine the discount rate by reference to market yields on US dollar denominated HQCB in another market or country such as the US (having concluded that there is a deep market in US dollar denominated HQCB), then the entity would not meet the requirements of paragraph 75 of IAS 19 because the actuarial assumptions would not be mutually compatible. The submitter's view is outlined in paragraph 8 of this paper. The submitter also says the use of a discount rate derived from market yields on HQCB from another market or country may be appropriate for entities operating in countries that are part of a regional market (such as the Eurozone). However, in the submitter's view, this is not appropriate for entities operating in countries (for example, Ecuador) that have adopted another country's currency as their legal or official currency without being part of a regional market.

29. As noted in paragraph 18 of this paper, in amending paragraph 83 of IAS 19 in 2014, the Board considered whether a discount rate derived from market yields on HQCB from another market or country could be inconsistent with the inflation rate and other actuarial assumptions used to determine the cost of providing post-employment benefits. Paragraph BC150F of IAS 19 states:

...[Some respondents] think that the proposed amendment could result in anomalous outcomes in these countries,

because a discount rate determined from high quality corporate bonds denominated in a stronger currency could be inconsistent with the inflation rate (and the other assumptions) used in these countries to determine the cost of providing post-employment benefits. The Board noted that this anomaly is not unique to the fact pattern raised. Instead, inflation rates in one location may be different to those in another, even if they are in the same country, state or regional market with a shared currency...

30. We agree with the Board's conclusion that differences, for example, in inflation rates would not be unique to the fact pattern raised. To illustrate, we have analysed the inflation rates in Ecuador and the US, which are not part of a regional market, and have compared them with inflation rates in Greece and Germany, which are part of a regional market (the Eurozone). Appendix C to this paper looks at trends in inflation rates from 2004-2015 for these countries. The inflation rate in Ecuador is different from the USA—in 2015, inflation in Ecuador of 4.0 per cent compares to inflation in the US of 0.1 per cent. However, this also applies to Greece where the inflation rate is different from that in Germany, despite both countries being part of the Eurozone—in 2015, inflation in Greece of minus 1.7 per cent compares to 0.2 per cent in Germany.

*Objective of the discount rate and the discount rate methodology*

31. To further assess whether determining a discount rate by reference to market yields on HQCB in another market or country would be mutually compatible with other actuarial assumptions in Ecuador, we have considered the objective of the discount rate and how this links to the discount rate methodology. Paragraph 84 of IAS 19 states:

The discount rate reflects the time value of money but not the actuarial or investment risk. Furthermore, the discount rate does not reflect the entity-specific credit risk borne by the entity's creditors, nor does it reflect the risk that future experience may differ from actuarial assumptions.

32. Paragraphs BC129-BC139 of IAS 19 (reproduced in Appendix B to this paper) outline considerations of the Board’s predecessor, the International Accounting Standards Committee (IASC), in selecting the discount rate methodology. The IASC considered whether the discount rate should be the expected rate of return on plan assets. As noted in paragraph BC130 of IAS 19, the IASC rejected this approach because ‘the fact that a fund has chosen to invest in particular kinds of asset does not affect the nature or amount of the obligation’. The IASC concluded that the measurement of the obligation should be ‘independent of the measurement of plan assets actually held by a plan’.
33. The IASC then considered whether the discount rate should be a risk-adjusted rate. The IASC’s conclusion is highlighted in paragraph BC134 of IAS 19. The IASC rejected an approach that would require entities to determine a discount rate on the basis of the expected return on an appropriate portfolio of assets. The IASC decided that the discount rate:
- (a) should reflect the time value of money;
  - (b) should not attempt to capture risks associated with the defined benefit obligation; and
  - (c) should not reflect the entity’s own credit rating.
34. The IASC concluded that the rate that best achieves these objectives is the market yield on HQCB. In currencies for which there is no deep market in HQCB, an entity uses the market yield on government bonds.
35. The wording in paragraph 84 of IAS 19 and the discussion in paragraphs BC129-BC137 of IAS 19 might be read to imply that the Board’s intention was for entities to use a risk-free rate. However, requiring entities to determine discount rates by reference to market yields on HQCB implies the inclusion of some level of credit risk, albeit at a relatively low level. Accordingly, there would appear to be no clear link between the objectives of the discount rate as specified in paragraph 84 of IAS 19 and the discount rate methodology (in paragraph 83 of IAS 19).
36. A country, like Ecuador, that adopts another country’s currency as its legal or official currency faces some unique risks. For example, the central bank of Ecuador is likely to have only limited control over the supply of US dollars in the market whereas this

is not the case in other circumstances, even in a regional market. Accordingly, there is a risk that an entity in Ecuador may not be in a position to fulfil its pension obligation by paying members in US dollars (because there may be a shortage of US dollars in the market at the time the entity is obliged to make payments to plan members). Similarly, there is a risk that the entity may not fulfil its pension obligation using US dollars because the Ecuadorian government might re-establish a separate currency for the country, and require some existing rights and obligations to be denominated in the new currency.

37. A discount rate derived from US dollar denominated government bonds issued in Ecuador would reflect some of these unique risks. These risks are not entity-specific but are more broadly applicable to all entities operating in that market.
38. Some say it is appropriate for entities in Ecuador or similar countries to determine a discount rate by reference to market yields on US dollar denominated HQCB, even if those HQCB are issued in a different market or country. This is because the objective of the discount rate is to reflect the time value of the currency (ie US dollars) and the IASC concluded that the market yield on HQCB best achieves this objective. In their view, it would be inappropriate to take into account other risks that might be specific to Ecuador (as outlined in paragraph 36 of this paper) because that could distort the depiction of the effect of the time value of the US dollar.
39. However, others say that that because the yield on HQCB is not a pure risk-free rate, the Board intended the rate to reflect some risks other than simply the time value of money. In their view, it is appropriate to reflect the macroeconomic risks of the environment in which an entity operates when determining the discount rate.
40. Given that there appears to be no clear link between the objective of the discount rate and the discount rate methodology, we think it is not possible to assess whether, and to what extent, the discount rate should be correlated to, or compatible with, other actuarial assumptions. Accordingly, we think there is no basis to support the submitter's statement that the determination of a discount rate based on market yields on HQCB from another market or country could, in the fact pattern submitted, lead to the use of actuarial assumptions that are not mutually compatible.

41. As discussed earlier in the paper, the discount rate methodology specified in paragraph 83 of IAS 19 is clear and unambiguous. We think, in the fact pattern in the submission, there is no basis to conclude, that this methodology could conflict with the requirement in paragraph 75 of IAS 19 for actuarial assumptions to be mutually compatible.

#### Question 2 for the Committee

Does the Committee agree with the staff's conclusion that there is no basis to conclude, in the fact pattern in the submission, that the use of the discount rate methodology in paragraph 83 of IAS 19 could conflict with the requirement in paragraph 75 of IAS 19 for actuarial assumptions to be mutually compatible?

#### ***Should the Committee add a project to clarify the objective of the discount rate?***

42. We considered whether the Committee (or the Board) should add a project to its agenda to clarify the objective of the discount rate. We do not recommend adding such a project. This is because:
- (a) we think it would not be possible for the Committee to address this issue without a fundamental reconsideration of the discount rate methodology (ie without revisiting whether the use of market yields on HQCB is appropriate or another methodology should be used). Reconsidering the methodology would represent a fundamental revision to IAS 19, which we think is too broad for the Committee to address as a narrow-scope project.
  - (b) the Committee previously (in 2013) discussed clarifying how the objective of the discount rate links to the discount rate methodology. It determined that issuing additional guidance on, or changing the requirements for, the discount rate methodology would be too broad for it to address in an efficient manner (see 'Interpretations Committee's work in progress' section from [IFRIC Update](#) May 2013); and
  - (c) the Board considered feedback on its research project on IAS 19 as part of its 2015 Agenda Consultation. [Agenda Paper 15](#) for the Board meeting in May 2016 identifies and discusses application issues identified regarding

the requirements in IAS 19. Paragraph 20 of that paper discusses feedback on the discount rate methodology, including a request to address the conceptual issue of whether the discount rate should reflect only the time value of money or also include a risk premium. On the basis of the feedback, the Board concluded that a review of IAS 19 was not a higher priority than other projects, and decided not to add a project on IAS 19 to its work plan, nor to include such a project in its research pipeline.

***Conclusion having considered the Committee’s agenda criteria***

43. The submitter asked us to consider how an entity in Ecuador, with pension obligations denominated in US dollars, applies the requirements in paragraph 83 of IAS 19 when determining the rate used to discount pension obligations. Applying paragraph 83 of IAS 19:
- (a) the entity assesses the depth of the market in HQCB denominated in US dollars. The entity does not limit this assessment to Ecuador (ie the market or country in which it operates), but also considers other markets or countries in which US dollar denominated HQCB are issued.
  - (b) if there is a deep market in US dollar denominated HQCB, the entity determines the discount rate by reference to market yields at the end of the reporting period on HQCB. This is the case even if there is no deep market in such bonds in Ecuador. In this situation, the entity does not use market yields on government bonds to determine the discount rate.
  - (c) if there is no deep market in US dollar denominated HQCB, the entity determines the discount rate using market yields on US dollar denominated government bonds.
  - (d) the entity applies judgement to determine the appropriate population of HQCB or government bonds to reference when determining the discount rate. The currency and term of the bonds must be consistent with the currency and estimated term of the pension obligations.
44. Given that there appears to be no clear link between the objective of the discount rate and the discount rate methodology, we think there is no basis to conclude that, in the

fact pattern in the submission, the application of the methodology required by paragraph 83 of IAS 19 would result in the use of actuarial assumptions that are not mutually compatible.

45. We think the requirements in IAS 19 provide an adequate basis for an entity to determine the discount rate. Accordingly, we have concluded that it is not necessary to add to or change IFRS Standards. We also think a project to clarify the objectives of the discount rate is too broad for the Committee to address.

### Staff recommendation

46. On the basis of our assessment of the Committee's agenda criteria, we recommend that the Committee does not add this issue to its agenda. Instead, we recommend publishing an agenda decision that includes educative guidance outlining how an entity applies the relevant principles and requirements in IAS 19 to the fact pattern in the submission.
47. Appendix A to this paper outlines the proposed wording of the tentative agenda decision.

#### Questions 3 and 4 for the Committee

3. Does the Committee agree with the staff recommendation not to add this issue to its agenda?
4. Does the Committee have any comments on the proposed wording of the tentative agenda decision outlined in Appendix A to this paper?



## Appendix A

### Proposed wording of the tentative agenda decision

#### **IAS 19 *Employee benefits*— Determining the discount rate in a country that has adopted another country's currency as its official or legal currency**

The IFRS Interpretations Committee (the Committee) received a request to clarify how an entity determines the rate used to discount post-employment benefit obligations (discount rate) in a country (ie Ecuador) that has adopted another currency as its official or legal currency (ie the US dollar). The entity's post-employment benefit obligation is denominated in US dollars. The submitter says there is no deep market for high quality corporate bonds in Ecuador.

The submitter asked whether, in that situation, the entity considers the depth of the market in US dollar denominated high quality corporate bonds in other markets or countries in which these bonds are issued (eg the United States of America). If there is no deep market in high quality corporate bonds denominated in US dollars, IAS 19 requires the entity to use the market yield on US dollar denominated government bonds when determining the discount rate. The submitter asked whether the entity can use market yields on US dollar denominated bonds issued by the Ecuadorian government or instead, is required to use market yields on US dollar denominated bonds issued by a government in another market or country (eg the United States of America).

The Committee observed that, applying paragraph 83 of IAS 19:

- (a) an entity with post-employment benefit obligations denominated in a particular currency assesses the depth of the market in high quality corporate bonds denominated in that currency. The entity does not limit this assessment to the market or country in which it operates, but also considers other markets or countries in which high quality corporate bonds denominated in that currency are issued.
- (b) if there is a deep market in high quality corporate bonds denominated in that currency, the entity determines the discount rate by reference to market yields at the end of the reporting period on high quality corporate bonds. This is the case even if there is no deep market in such bonds in the market or country in which the entity operates. In this situation, the entity does not use market yields on government bonds to determine the discount rate.
- (c) if there is no deep market in high quality corporate bonds denominated in that currency, the entity determines the discount rate using market yields on government bonds denominated in that currency.
- (d) the entity applies judgement to determine the appropriate population of high quality corporate bonds or government bonds to reference when determining the discount rate. The currency and term of the bonds must be consistent with the currency and estimated term of the post-employment benefit obligations.

In addition, the Committee considered the interaction between the requirements in paragraphs 75 and 83 of IAS 19. Paragraph 75 of IAS 19 requires actuarial assumptions to be mutually

compatible. The Committee observed that there is no basis to conclude that the application of the requirements in paragraph 83 of IAS 19 by an Ecuadorian entity with US dollar denominated post-employment benefit obligations would result in the use of actuarial assumptions that are not mutually compatible. This is because there appears to be no clear link between the objective of the discount rate in paragraph 84 of IAS 19 and the requirements in paragraph 83 of IAS 19. Accordingly, the entity applies the requirements in paragraph 83 of IAS 19 when it determines the discount rate.

The Committee concluded that the principles and requirements in IAS 19 provide an adequate basis for an entity to determine the discount rate in the fact pattern in the submission.

In the light of the existing requirements in IFRS Standards, the Committee [determined] that neither an Interpretation nor an amendment to a Standard was necessary. Consequently, the Committee [decided] not to add this issue to its agenda.

## Appendix B

### Paragraphs BC129-BC139 of IAS 19 (reproduced for ease of reference)

#### Actuarial assumptions—discount rate

- BC129 One of the most important issues in measuring defined benefit obligations is the selection of the criteria used to determine the discount rate. According to IAS 19 before its revision in 1998, the discount rate that was assumed in determining the actuarial present value of promised retirement benefits reflected the long-term rates, or an approximation thereto, at which such obligations were expected to be settled. IASC rejected the use of such a rate because it was not relevant for an entity that does not contemplate settlement and it was an artificial construct, because there may be no market for settlement of such obligations.
- BC130 Some believe that, for funded benefits, the discount rate should be the expected rate of return on the plan assets actually held by a plan, because the return on plan assets represents faithfully the expected ultimate cash outflow (ie future contributions). IASC rejected this approach because the fact that a fund has chosen to invest in particular kinds of asset does not affect the nature or amount of the obligation. In particular, assets with a higher expected return carry more risk and an entity should not recognise a smaller liability merely because the plan has chosen to invest in riskier assets with a higher expected return. Consequently, the measurement of the obligation should be independent of the measurement of any plan assets actually held by a plan.
- BC131 The most significant decision was whether the discount rate should be a risk-adjusted rate (one that attempts to capture the risks associated with the obligation). Some expressed the view that the most appropriate risk-adjusted rate is given by the expected return on an appropriate portfolio of plan assets that would, over the long term, provide an effective hedge against such an obligation. An appropriate portfolio might include:
- (a) fixed interest securities for obligations to former employees to the extent that the obligations are not linked, in form or in substance, to inflation;
  - (b) index-linked securities for index-linked obligations to former employees; and
  - (c) equity securities for benefit obligations towards current employees that are linked to final pay. This is based on the view that the long-term performance of equity securities is correlated with general salary progression in the economy as a whole and hence with the final-pay element of a benefit obligation.

It is important to note that the portfolio actually held need not necessarily be an appropriate portfolio in this sense. Indeed, in some countries, regulatory constraints may prevent plans from holding an appropriate portfolio. For example, in some countries, plans are required to hold a specified proportion of their assets in the form of fixed interest securities. Furthermore, if an appropriate portfolio is a valid reference point, it is equally valid for both funded and unfunded plans.

- BC132 Those who support using the interest rate on an appropriate portfolio as a risk-adjusted discount rate argue that:
- (a) portfolio theory suggests that the expected return on an asset (or the interest rate inherent in a liability) is related to the undiversifiable risk associated with that asset (or liability). Undiversifiable risk reflects not the variability of the returns (payments) in absolute terms but the correlation of the returns (or payments) with the returns on other assets. If cash inflows from a portfolio of assets react to changing economic conditions over the long term in the same way as the cash outflows of a defined benefit obligation, the undiversifiable risk of the obligation (and hence the appropriate discount rate) must be the same as that of the portfolio of assets.
  - (b) an important aspect of the economic reality underlying final salary plans is the correlation between final salary and equity returns that arises because they both reflect the same long-term economic forces. Although the correlation is not perfect, it is sufficiently strong that ignoring it will lead to systematic overstatement of the liability. In addition, ignoring this correlation will result in misleading volatility due to short-term fluctuations between the rate used to discount the obligation and the discount rate that is implicit in the fair value of the plan assets. These factors will deter entities from operating defined benefit plans and lead to

switches from equities to fixed-interest investments. Where defined benefit plans are largely funded by equities, this could have a serious impact on share prices. This switch will also increase the cost of pensions. There will be pressure on companies to remove the apparent (but non-existent) shortfall.

- (c) if an entity settled its obligation by purchasing an annuity, the insurance company would determine the annuity rates by looking to a portfolio of assets that provides cash inflows that substantially offset all the cash flows from the benefit obligation as those cash flows fall due. Consequently, the expected return on an appropriate portfolio measures the obligation at an amount that is close to its market value. In practice, it is not possible to settle a final pay obligation by buying annuities because no insurance company would insure a final pay decision that remained at the discretion of the person insured. However, evidence can be derived from the purchase or sale of businesses that include a final salary pension scheme. In this situation the vendor and purchaser would negotiate a price for the pension obligation by reference to its present value, discounted at the rate of return on an appropriate portfolio.
- (d) although investment risk is present even in a well-diversified portfolio of equity securities, any general decline in securities would, in the long term, be reflected in declining salaries. Because employees accepted that risk by agreeing to a final salary plan, the exclusion of that risk from the measurement of the obligation would introduce a systematic bias into the measurement.
- (e) time-honoured funding practices in some countries use the expected return on an appropriate portfolio as the discount rate. Although funding considerations are distinct from accounting issues, the long history of this approach calls for careful scrutiny of any other proposed approach.

BC133 Those who oppose a risk-adjusted rate argue that:

- (a) it is incorrect to look at returns on assets in determining the discount rate for liabilities.
- (b) if a sufficiently strong correlation between asset returns and final pay actually existed, a market for final salary obligations would develop, yet this has not happened. Furthermore, where any such apparent correlation does exist, it is not clear whether the correlation results from shared characteristics of the portfolio and the obligations or from changes in the contractual pension promise.
- (c) the return on equity securities does not correlate with other risks associated with defined benefit plans, such as variability in mortality, timing of retirement, disability and adverse selection.
- (d) in order to evaluate a liability with uncertain cash flows, an entity would normally use a discount rate lower than the risk-free rate, but the expected return on an appropriate portfolio is higher than the risk-free rate.
- (e) the assertion that final salary is strongly correlated with asset returns implies that final salary will tend to decrease if asset prices fall, yet experience shows that salaries tend not to decline.
- (f) the notion that equities are not risky in the long term, and the associated notion of long-term value, are based on the fallacious view that the market always bounces back after a crash. Shareholders do not get credit in the market for any additional long-term value if they sell their shares today. Even if some correlation exists over long periods, benefits must be paid as they become due. An entity that funds its obligations with equity securities runs the risk that equity prices may be down when benefits must be paid. In addition, the hypothesis that the real return on equities is uncorrelated with inflation does not mean that equities offer a risk-free return, even in the long term.
- (g) the expected long-term rate of return on an appropriate portfolio cannot be determined sufficiently objectively in practice to provide an adequate basis for an accounting standard. The practical difficulties include specifying the characteristics of the appropriate portfolio, selecting the time horizon for estimating returns on the portfolio and estimating those returns.

BC134 IASC had not identified clear evidence that the expected return on an appropriate portfolio of assets provides a relevant and reliable indication of the risks associated with a defined benefit obligation, or that such a rate can be determined with reasonable objectivity. Consequently, IASC decided that the

discount rate should reflect the time value of money, but should not attempt to capture those risks. Furthermore, the discount rate should not reflect the entity's own credit rating, because otherwise an entity with a lower credit rating would recognise a smaller liability. IASC decided that the rate that best achieves these objectives is the yield on high quality corporate bonds. In countries where there is no deep market in such bonds, the yield on government bonds should be used.

- BC135 Another issue was whether the discount rate should be the long-term average rate, based on past experience over a number of years, or the current market yield at the balance sheet date for an obligation of the appropriate term. Those who supported a long-term average rate expressed the view that:
- (a) a long-term approach is consistent with the transaction-based historical cost approach that was either required or permitted by other International Accounting Standards.
  - (b) point in time estimates aim at a level of precision that is not attainable in practice and lead to volatility in reported profit that may not be a faithful representation of changes in the obligation, but may simply reflect an unavoidable inability to predict accurately the future events that are anticipated in making period-to-period measurements.
  - (c) for an obligation based on final salary, neither market annuity prices nor simulation by discounting expected future cash flows can determine an unambiguous annuity price.
  - (d) over the long term, a suitable portfolio of plan assets may provide a reasonably effective hedge against an employee benefit obligation that increases in line with salary growth. However, there is much less assurance that, at a given measurement date, market interest rates will match the salary growth built into the obligation.
- BC136 IASC decided that the discount rate should be determined by reference to market yields at the balance sheet date, because:
- (a) there is no rational basis for expecting efficient market prices to drift towards any assumed long-term average, because prices in a market of sufficient liquidity and depth incorporate all publicly available information and are more relevant and reliable than an estimate of long-term trends by any individual market participant.
  - (b) the cost of benefits attributed to service during the current period should reflect prices of that period.
  - (c) if expected future benefits are defined in terms of projected future salaries that reflect current estimates of future inflation rates, the discount rate should be based on current market interest rates (in nominal terms), because these also reflect current market expectations of inflation rates.
  - (d) if plan assets are measured at a current value (ie fair value), the related obligation should be discounted at a current discount rate in order to avoid introducing irrelevant volatility through a difference in the measurement basis.
- BC137 The reference to market yields at the balance sheet date did not mean that short-term discount rates should be used to discount long-term obligations. IAS 19 requires that the discount rate should reflect market yields (at the balance sheet date) on bonds with an expected term that is consistent with the expected term of the obligations.

### **Actuarial assumptions—discount rate: exposure draft published in 2009**

- BC138 The discount rate requirements in IAS 19 may result in an entity reporting a significantly higher defined benefit obligation in a jurisdiction that does not have a deep market in high quality corporate bonds than it would in a similar jurisdiction that does have a deep market in such bonds, even when the underlying obligations are very similar.
- BC139 To address this issue, in August 2009 the Board published an exposure draft *Discount Rate for Employee Benefits*, that proposed eliminating the requirement to use a government bond rate if there is no deep market in high quality corporate bonds. However, responses to that exposure draft indicated that the proposed amendment raised more complex issues than had been expected. After considering those responses, the Board decided not to proceed with the proposals but to address issues relating to the discount rate only in the context of a fundamental review (see [paragraph BC13\(b\)](#)).

## Appendix C Comparison of inflation rates

### Inflation, consumer prices (annual %)

International Monetary Fund, International Financial Statistics and data files.

License: [Open](#)



#### Overview per country

Country	2004	2015	
Ecuador	2.7	4.0	
United States	2.7	0.1	

## Inflation, consumer prices (annual %)

International Monetary Fund, International Financial Statistics and data files.

License: [Open](#)



### Overview per country

Country	2004	2015	
Germany	1.7	0.2	
Greece	2.9	-1.7	

## Appendix D Submission

D1. We received the following request. We have deleted details that would identify the submitter of this request.

### IFRS INTERPRETATIONS COMMITTEE POTENTIAL AGENDA ITEM REQUEST

#### 1. THE ISSUE:

#### Use of the discount rate under clarified IAS 19 in countries that have adopted a stronger currency

Dear Members of the

IFRS INTERPRETATIONS COMMITTEE (IFRS IC),

We hope this letter finds you well.

We would like to share with you a particular situation that is being presented in Ecuador (a country that have adopted a stronger currency – US dollar) this year in the preparation of financial statements under IFRS.

In the document *Annual Improvements to IFRSs 2012–2014 Cycle* issued in September 2014, an amendment was made to paragraph 83 of IAS 19 (deleted text is struck through and new text is underlined):

#### **Actuarial assumptions: discount rate**

*83. The rate used to discount post-employment benefit obligations (both funded and unfunded) shall be determined by reference to market yields at the end of the reporting period on high quality corporate bonds. ~~In For countries~~ currencies ~~where~~ for which there is no deep market in such high quality corporate bonds, the market yields (at the end of the reporting period) on government bonds denominated in that currency shall be used. 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.*

An entity shall apply that amendment for annual periods beginning on or after 1 January 2016. Some professionals in Ecuador has interpreted this amendment as using the yield of US government bonds as a discount rate.



However, according to what we have researched and analyzed, we understand that this amendment is only a clarification of the principles that already existed in previous years in IAS 19 about the discount rate.

In June 2005 the Interpretations Committee decided 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).”

In January 2013 the Interpretations Committee confirmed this position and clarified that “for a liability expressed in euro, the deepness of the market of high quality corporate bonds should be assessed at the Eurozone level”-

That is, the possibility of using the bond yield of other countries was actually available from before the amendment to paragraph 83 of IAS 19.

In previous years, actuarial calculations in Ecuador for the post-employment benefit liability have used the yields of the Ecuadorian government bonds, because in this way the actuarial assumptions used in these calculations are compatible with each other (paragraphs 75 to 80 of IAS 19). Since paragraph 83 of IAS 19 has only been clarified (but the principle of the standard has not been changed), it would be appropriate to continue to use the same discount rate in 2016, in order to maintain consistency and comply with paragraphs 75 to 80 of IAS 19.

It is important to note that, in the previous years, there was no qualification in the opinions expressed in the independent audit reports in Ecuador regarding the actuarial calculations and amounts presented in the financial statements (despite the fact that there was an option to use bond yields from other countries in the same currency).

From the reading of paragraph 83 of IAS 19, we can denote an existing hierarchy, which we could call 'Level 1' and 'Level 2', when choosing the appropriate discount rate for the actuarial calculation of the post-employment benefit liability:

- 1. Level 1:** Use the yields of high-quality corporate (or corporate) bonds (HQCB).
- 2. Level 2:** In currencies where there is no deep (or broad) market for high-quality corporate bonds, government bond yields will be used.

#### *Applying 'Level 1' of amended paragraph 83 of IAS 19*

In that vein, applying the existing hierarchy in the amended paragraph 83 of IAS 19, we first evaluated the yield of high quality corporate bonds (HQCB) issued in dollars. In the Ecuadorian context, it should be noted that there is no deep market for these bonds. However, as the amendment to paragraph 83 contemplates the analysis of bonds in the same currency, in theory, we can consider the yields of high-quality corporate bonds from deep markets that issue bonds in dollars, such as the United States, for example.

However, using HQCB returns on the US market would not meet the requirements of paragraphs 75-80 of the current IAS 19, as we would be transgressing the very principles of actuarial mathematics and corporate finance<sup>1</sup>.

This is because the US market is significantly different from the Ecuadorian market. Therefore, such a US discount rate would be inconsistent and biased in relation to other actuarial assumptions that are based on the Ecuadorian economic reality. In short, in the Ecuadorian context, establishing the discount rate through the HQCB yields is not applicable.

Using HQCB returns as a discount rate on a national or regional market would in practice be reasonable for certain eurozone countries that have deep markets and share similar macroeconomic variables so that actuarial assumptions are compatible and unbiased for estimates of post-employment benefit liabilities<sup>2</sup>.

As can be seen from the background, this amendment is actually born due to the concerns of eurozone countries. The eurozone is a term used to refer to countries that use the euro (€) as common currency. In this way, we can say that the eurozone is a monetary union established within the European Union. It should be remembered that not all the countries of the European Union use the Euro as official currency. There are currently 17 EU Member States (considered official members) that are part of the eurozone. There are also countries and territories that are not part of the European Union but use the euro as official currency<sup>3</sup>. Monetary policies related to the euro area are defined by the European Central Bank. The creation of the Eurozone was on January 1, 1999.

The euro zone generally has the following economic characteristics:

- a. Price stability.
- b. Greater transparency in prices.
- c. There are no fluctuations in the exchange rate between members.

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<sup>1</sup> Based on Arthur W. Anderson (2006), *Pension Mathematics for Actuaries* (3rd. Edition). Chapter 6: *Assumptions*. ACTEX Publications.

<sup>2</sup> Based on International Actuarial Association (2013), Case Study 10: Eurozone IAS 19 Pension. Discount Rates in Financial Reporting. International Actuarial Association.

<sup>3</sup> In accordance with paragraph FC150F of the Basis for Conclusions of the amendment to paragraph 83 of IAS 19, some respondents to the Exposure Draft of the *Annual Improvements* expressed concern about the potential effects of the amendment in countries that have adopted a stronger currency as its legal or official currency without being members of a regional market or part of one with a common currency. They thought that the proposed change could lead to anomalous results in these countries because a discount rate determined from high-quality corporate bonds denominated in a stronger currency could be inconsistent with the rate of inflation (and other assumptions) used in these countries to determine the cost of providing post-employment benefits. The IASB emphasized that this anomaly is not unique in the factual structure proposed. Instead, inflation rates in one location may be different from those in another, even if they are in the same market as a country, state or region with a shared currency. However, on page 8 of *Staff Paper 17D* the technical staff of the IFRS Foundation state that they agree that entities operating in these **countries should carefully consider whether a discount rate determined using HQCBs issued in other countries is compatible with other actuarial assumptions**. That is, considering the yield of bonds of other countries with which a regional market or a market with a common currency is not shared, although permitted by the international standard, would only apply if the actuarial assumptions in the calculation are compatible (complying with paragraphs 75-80 of IAS 19). This situation is not met between the United States and Ecuador, even if they share the same currency.

- d. A greater security of the currency attracts more investment.
- e. A larger unified market attracts more foreign investment.
- f. More investment brings more economic activity and more employment.
- g. Generates more integrated financial markets.
- h. Eliminates transaction costs among member countries, including:
  - i. The purchase and sale of foreign currencies in the foreign exchange markets.
  - ii. Eliminates exchange rate fluctuations.
  - iii. Eliminates cross-border payments in foreign currency, involving high costs.
  - iv. Eliminates the need to maintain multiple currency accounts that make account management more complicated.
- i. The value of the euro remains stronger and tends to suppress inflation, which is positive for the economy.
- j. The more stable and less inflationary currency results in lower interest rates.
- k. Facilitates economic mobility.
- l. Expands access to a broader capital base.

Ecuador and the United States, even if they use the dollar as currency, do not share the same economic characteristics as some of the member countries of the eurozone. The context of the eurozone is due to a region that jointly determined the adoption of the euro as a single currency with a central European bank, however, the Latin American context is not due to a "dollarzone", but to the urgency of having dollarized the economy and not by the adoption of centralized monetary guidelines.

There are countries and territories that are not part of the European Union but use the euro as official currency. In assessing the discount rate for the actuarial calculation of the post-employment benefit liability, these countries can conduct their analysis at the currency level, taking into consideration the yields of euro bonds from other countries. In some cases, this assessment is appropriate because some countries that have the euro as their currency share similar economic characteristics and because of the context of low interest rates in many European countries. This is why, in these particular situations, the analysis of bond yields at the level of the same currency can be carried out even without the need for the countries evaluated to be part of a regional or common market.

However, for example, if Venezuela - a Latin American country currently with hyperinflation - decided to adopt the US dollar as the official currency, Venezuelan entities should not automatically use the US bond rate in their actuarial calculations just for sharing the same currency, since post-employment benefits would not be reflecting the economic reality of companies operating in that country.

In addition, if Venezuela were to adopt the US dollar as the currency and companies would use the discount rate on US bonds by interpretation of amended paragraph 83 of IAS 19, it would be using lower discount rates as compared to discount rates used by the other Latin American countries that do not have hyperinflation, which would seem to make no sense.

For example, when assessing the impairment of assets of an entity in accordance with IAS 36, an entity may use the Capital Assets Pricing Model (CAPM) or the weighted average cost of capital (WACC) for estimating the discount rate of the projected cash flows when calculating the 'value in use'. In calculating the cost of debt ( $K_d$ ) and shares ( $K_s$ ) to obtain

the WACC, the entity uses variables of its economic reality and its financing structure, so that an asset can be correctly evaluated to adjust an impairment or not. The CAPM or WACC calculation is also based on corporate finance principles, and in practice, its calculation is differentiated when dealing with an entity operating in deep markets or emerging economies (non-deep markets). That is, at the time of calculating the WACC or use CAPM, companies operating in an emerging economy (non-deep market) do not use the same discount rate as companies operating in a deep market<sup>4</sup>.

To maintain consistency with the above, when assessing liabilities (particularly a liability for post-employment benefits), the variables used must also be based on the economic reality of the entity. An entity should use a discount rate related to the financial performance of its plan assets (if the post-employment benefit plan is funded), which in some cases relates to the market returns of the country in which operates the entity. If the post-employment benefit liability is not funded by plan assets, the entity must consider the performance of its financial assets, which in emerging economies is related generally to the market performance of the country in which it operates, although that economy is dollarized.

The amended paragraph 83 should not disregard the principles of consistency contemplated in the other paragraphs of IAS 19 and other IFRS. Otherwise, an accounting asymmetry and an inconsistency in the actuarial calculation would be generated.

The previous analysis not only of relevance for Ecuador, but also for other countries like El Salvador and Panama that also are dollarized. Also for countries, like Zimbabwe that denominate the payment of his employees benefits in US dollars.

#### *Applying 'Level 2' of amended paragraph 83 of IAS 19*

Following the hierarchy of the amended paragraph 83 of IAS 19, it would then be appropriate to use government bond yields, as a discount rate, of course, keeping in line with the currency and the estimated period of payment of post-employment benefit obligations. As we have shown above, IAS 19 does not specify the degree to which the performance of government bonds (or corporate bonds) should be evaluated. It does not specify to take as reference the yields of national, regional or any part of the world bonds.

Therefore, using professional judgment, and consistent with the principles of actuarial mathematics and corporate finance, it is appropriate to use bond yields from the Ecuadorian government (ie, only to a national level). As of December 31, 2016, the discount rate estimated by actuaries in Ecuador is 7.46%.

We do not consider it appropriate to estimate a discount rate from US government bonds of approximately 3%, since actuarial assumptions would not be compatible.

Technically, it is not appropriate to discount the cash flows of a 'non-deeper market' country by using a 'deep market' country rate when the entity that discounts the flows is funded with local financial assets and financing with local entities, mainly<sup>5</sup>. That would lead to 'accounting and actuarial asymmetry'.

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<sup>4</sup> Based on Guillermo L. Dumrauf (2010), Chapter 8: Modelos de valuación de activos de capital. Finanzas Corporativas – Un Enfoque Latinoamericano (2nd. Edition). Alfaomega.

<sup>5</sup> Based on David C.M. Dickson, Mary R. Hardy & Howard R. Waters (2016), Chapter 10: *Pension mathematics* and Chapter 11: Yield curves and non-diversificable risk. *Actuarial Mathematics for Life Contingent Risks (2<sup>nd</sup>*

We understand that the spirit of IAS 19 as amended is not to go against the principles of actuarial mathematics or corporate finance.

Consequently, by taking into account the performance of the Ecuadorian government bonds in estimating the discount rate, it would not be in breach or create a deviation from the principles of IAS 19, in a comprehensive approach. And the estimates of the post-employment benefit liabilities reflected in the financial statements of the Ecuadorian companies will be actuarially and financially sound.

## Impacts and conclusions

The amendment to paragraph 83 of IAS 19 would have no effect on the actuarial valuation of post-employment benefit liabilities in the Ecuadorian context.

The following conclusions are therefore highlighted:

- The amendment to paragraph 83 of IAS 19 reflects a clarification on a principle that already existed in the standard. That is, this amendment does not change the principles in IAS 19 on the discount rate.
- In previous years, the actuarial calculations in Ecuador were using as a discount rate the yield of the Ecuadorian government bonds. In these previous years, the audit reports in Ecuador did not make an opinion that there was any breach of IAS 19, despite the fact that the same principles on the discount rate existed. Therefore, maintaining the use of the Ecuadorian government bond yields as a discount rate should not generate any discrepancy in the audit opinion of the current reports, if we remain consistent.
- Using the yield of US bonds (from corporates or government) as the discount rate would be inconsistent with the other actuarial assumptions used in the actuarial calculation for the post-employment benefit liability, since the latter are based on the Ecuadorian economic reality. For this reason, the discount rate used in Ecuador takes into account the performance of government bonds within its calculation, resulting in 7.46%.
- If US government bond yields were used, for example, instead of the performance of Ecuadorian government bonds, the discount rate used in the actuarial calculation would be lower (3% < 7.46%). With the discount rate being lower, the new estimate of post-employment benefits liability would be significantly higher, adversely affecting the company's key financial ratios, such as the 'debt ratio'. This restatement of the liabilities would materially reduce the accumulated results, which would negatively affect the dividend distribution capacity of the company.
- We have been able to develop a technical analysis document called '*Actuarial valuation and calculation of the discount rate applicable under IAS 19 - Employee Benefits in the Ecuadorian context*'. We are pleased to share this document attached to this letter, hoping it would be useful to the IFRS Interpretations Committee. By Staff Paper 17D that we have analyzed, we understand that the IFRS Foundation technical staff would be interested in analyzing the effect of this amendment on countries that have adopted a stronger currency, such as Ecuador.

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*edition*). Institute and Faculty of Actuaries. Cambridge University Press. Also based on Howard E. Winklevoss (1993), Chapter 2: Actuarial Assumptions. *Pension Mathematics with Numerical Illustrations (2<sup>nd</sup> edition)*. Pension Research Council – Wharton School of the University of Pennsylvania.

This analysis document is divided into three parts:

1. Background.
2. Fully applying IAS 19: the principles of actuarial calculations and corporate finance.
3. Analysis of impacts and conclusions.

This document describes the background of the amendment to paragraph 83 of IAS 19, it also discusses why it would be technically appropriate to use the performance of government bonds from Ecuador a discount rate for actuarial calculations.

This PDF document consists of 22 pages and contains more than 18 technical references. In order to provide technical strength to the document in the actuarial analysis, this document provides an annex, which details step by step, in numbers, the actuarial calculation of a liability for post-employment benefits, comparing the value obtained when using a discount rate based on the Ecuadorian government bonds (7.46%) and the US government bonds (3%). A PowerPoint presentation summarizing the main points of the technical analysis document in PDF is also attached. The PDF document and the PowerPoint presentation are in Spanish.

Also, to this email is attached a zipped folder called '*IFRS IC - Soportes*' with supports of the document: the file in Excel with the tables of the actuarial calculation, and other sources in PDF cited in the technical analysis document (staff papers and others).

If the IFRS IC or the IFRS Foundation consider it necessary to translate the documents from Spanish to English, please feel free to do so. In advance you have our authorization for it.

## **2. CURRENT PRACTICE:**

This is the first year that the amended paragraph 83 of IAS 19 is being applied. There is currently no consensus in Ecuador on the discount rate to be used. There is an important discussion between companies, audit firms, actuaries and regulators.

Some believe that US bond yields should now be used as a discount rate, and others consider that the use of bond yields from the Ecuadorian government should be maintained.

We consider that in this analysis of the discount rate, not only the audit firms and IFRS specialists play an important role, but also the criteria of actuaries. We have consulted this analysis with various actuaries in Ecuador, and within the principles of actuarial mathematics, they have commented to me that the correct thing would be to use the yield of the Ecuadorian bonds as a discount rate, due to the particular economic situation.

This is probably the same situation in other countries that have adopted a stronger currency or have denominated their employee benefit payments in a stronger currency.

## **3. REASONS FOR THE IFRS IC TO ADDRESS THE ISSUE:**

According to the above analysis, we want to consult if our interpretation is correct. That is to say: Would the principles of IAS 19 be breached if a company in a country with a non-deep bond market uses only the yield of Ecuadorian bonds as a discount rate because using the bond yield of other countries with the same currency results in incompatible actuarial assumptions?

*(a) Is the issue widespread and has, or is expected to have, a material effect on those affected?*

We consider that the assessment of the use of bond yields from other countries with the same currency in estimating the discount rate in accordance with amended paragraph 83 is not only limited to those economies that have adopted a stronger currency. We believe that emerging markets with non-deep bond markets should also be very careful in selecting their discount rate when they want to take into account bond yields from other developed countries with deep markets and the same currency, while striving to maintain consistency between different actuarial assumptions in the calculations.

The various interpretations on the use of the discount rate by the amended paragraph 83 of IAS 19 will lead to a variety of practices in the estimation of the discount rate, in breach of the principle of comparability of financial information.

*(b) Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?*

If Ecuadorian companies use the US bonds yield (instead of the yield on Ecuadorian government bonds) as a discount rate, their post-employment benefit liability would increase more than double. This will significantly affect their cumulative earnings (equity), and hence their capacity to distribute dividends. All of this would lead to a fall in the shares price of these companies.

*(c) Can the issue be resolved efficiently within the confines of IFRSs and the Conceptual Framework for Financial Reporting?*

If the IFRS IC could clarify this situation, it would eliminate the various interpretations that are being generated on amended paragraph 83 of IAS 19 on the use of the discount rate in economies that have adopted a stronger currency. This would favor the quality of financial reporting and comparability in companies operating in these countries.

*(d) Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process?*

We believe that this situation can be resolved within the confines of IAS 19 and the Framework.

*(e) Will the solution developed by the Interpretations Committee be effective for a reasonable time period? The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified.*

We would appreciate your kind response, since we would have a long-term solution on this issue that we consider important.

We believe it would be valuable if the global offices of audit firms also reconsidered this issue. So that they can provide new guidelines for their regional offices operating in countries of emerging economies or that have adopted a stronger currency, after a new debate on this subject and knowing the new deliberations of IFRS IC.

We hope this information could be useful and taken into account by the IFRS IC. Please, the analysis and criteria of the IFRS IC will be very valuable to obtain a solution to this issue.

If any additional information is needed from us, we would be glad to be at your service. We appreciate your kind attention and look forward to your comments.