

## STAFF PAPER

January 2020

IASB<sup>®</sup> Meeting

Project	Pension Benefits that Depend on Asset Returns		
Paper topic	Project update		
CONTACT(S)	Filippo Poli	<a href="mailto:fpoli@ifrs.org">fpoli@ifrs.org</a>	+44 (0) 20 7246
	Anuj Deuba	<a href="mailto:adeuba@ifrs.org">adeuba@ifrs.org</a>	+44 (0) 20 7246

This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS<sup>®</sup> Standards or the *IFRS for SMEs*<sup>®</sup> Standard do not purport to set out acceptable or unacceptable application of IFRS Standards or the *IFRS for SMEs*<sup>®</sup> Standard. Technical decisions are made in public and reported in IASB<sup>®</sup> *Update*.

## Purpose

1. This paper has the following objectives:
  - (a) remind the Board about the nature of the project and the prior discussions;
  - (b) provide a description of the model being explored in this project; and
  - (c) provide a timetable for the next steps.
2. We will not ask the Board to take any decision at this session.

## Structure of this paper

3. This paper is structured as follows:
  - (a) background and history of the project (paragraphs 4–25);
  - (b) description of the “capped” ultimate costs adjustment model that is being explored (paragraphs 26–33);
  - (c) next steps (paragraphs 34–39); and
  - (d) question to the Board.

## Background and history of the project

4. An entity classifies post-employment benefits as defined contribution (DC) plans or defined benefit (DB) plans in accordance with paragraphs 26–31 of IAS 19 *Employee Benefits*. IAS 19 defines a DC plan as a post-employment plan under which an entity pays specified contributions into a separate entity and will have no obligation to pay further contributions if the fund does not hold sufficient assets to pay all benefits relating to service in the current and prior period.
5. A post-employment plan that is not a DC plan is a DB plan and an entity must use the projected unit credit method to estimate the ultimate cost to the entity in return for the employees' service in the current and prior periods, attributing benefits to periods of service. Using the actuarial technique with this method, an entity calculates the present value of the defined benefit obligation (DBO), discounted using bond rates in accordance with paragraphs 83–86 of IAS 19.
6. An entity determines the deficit or surplus as the difference between the present value of the DBO and the fair value of its related plan assets. The amount of the deficit or surplus is recognised as a net defined benefit liability (asset) in the statement of financial position, subject to the effect of the asset ceiling.
7. In traditional DB plans, actuarial and investment risk fall on the entity. The accounting in IAS 19 has provided useful information for these traditional DB plans. However, more recently traditional defined benefit plans have come under pressure due to a combination of increased longevity of plan participants, reduction in active workforce and decreasing, or even negative, investment yields.
8. As a result, entities have moved away from traditional plans and have tried to introduce risk-sharing features. Plans with these characteristics - that encompass a range of different alternatives - are often referred to as "hybrid plans".
9. Example of these hybrid plans include:
  - (a) career average DB plans with conditional indexation. In these plans, the indexing of the career average to keep pace with inflation is contingent on how well the plan is funded. This shifts part of the investment risk from the sponsoring entities to participants;

- (b) variable annuity plans, that provide for an automatic adjustment of benefits that is tied to the investment performance of the underlying assets. Other variable annuity plans may instead adjust the level of contributions from participants depending on the level of funding;
  - (c) floor offset plans, also known as underpin plans, where the benefit is the greater of the amount provided by a DC plan and a guarantee, which may be a money back guarantee;
  - (d) cash balance plans, where each participant has a hypothetical account. The account is periodically credited with a contribution based on the current year salary and a return based on a fixed or variable rate that is not required to depend on the performance of the plan assets;
  - (e) plans that shift life expectancy risk and/or interest rate risk to participants at the point of retirement. These plans can either pay benefits as a lumpsum, thus transferring the life expectancy risk to participants, or convert the amount into an annuity based on interest rates current at retirement.
10. In some hybrid plans, the benefits paid to employees depend, wholly or partly, on the return on a specified pool of assets. IAS 19 requires projecting the benefit on the basis of an assumption of future performance of the specified assets, often assumed to be higher than bond rates. The benefits are then discounted back using the rate specified in IAS 19.
11. For example, suppose a plan promised a benefit equal to contributions plus the rate of return on a specified pool of assets. If the annual contributions amount to 100 LC, the currently expected rate of return is 5% and the discount rate specified by IAS 19 is 3%, under existing IAS 19 requirements an entity would measure the defined benefit obligation by projecting forward the cash outflows at the expected rate of return of 5% and then discounting the cash flows back at 3%, which would result in a present value of 102 LC.

12. This measurement is subject to two criticisms:
- (a) it does not depict faithfully any attribute of the asset. It differs from the fair value of the underlying reference assets that determine the amount of the payment to employees. It results from combining cash flows with a discount rate that is determined on a different basis; and
  - (b) in addition, in many cases, the reference assets that determine the amount of the payment to employees are held by the plan. Those plan assets are required to be measured at fair value. The fair value of the plan assets reflects the market price of the risk inherent in future cash flows from the plan assets. In contrast, the present value of the DBO does not reflect the market price of that risk. This difference in measurement basis can result in the entity booking a net liability even if the entity is not expected to pay additional contributions for services received in past and present periods.

*History of consideration of benefits provided by hybrid plans*

13. In 2004, the IFRS Interpretations Committee (Committee) issued Draft Interpretation D9 *Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions*, to address the treatment of plans with a promise depending on asset returns. In November 2006, the Committee referred the issue to the IASB to be included in the IASB's project on post-employment benefits.
14. The Board initially included this issue in its project on post-employment benefits. The 2008 Discussion Paper *Preliminary Views on Amendments to IAS 19 Employee Benefits* included proposals to address contribution-based promises, which were tentatively defined as promises in which, during the accumulation phase, the benefit could be expressed as:
- (a) the accumulation of actual or notional contributions that, for any reporting period, would be known at the end of the period, except for the effect of any vesting or demographic risk; and
  - (b) any promised return on the contributions is linked to the return of an asset, group of assets or an index. A contribution-based promise needs not include a promised return.

15. However, the Board decided in 2009 to defer consideration of these promises to a future broad-scope project. As a consequence, this issue was not addressed by amendments made to IAS 19 in 2011.
16. During the Board's work on these issues, some constituents expressed concerns that IAS19's requirement to use market yields on government bonds when there is no deep market in corporate bonds was creating significant differences in reported amounts between entities with similar employee benefit obligation. To address this concern, in August 2009, the Board published the Exposure Draft *Discount Rate for Employee Benefits*.
17. The Exposure Draft (ED) proposed to remove the requirement to use a government bond rate when there is no deep market in high quality corporate bonds. An entity would be required to estimate the rate for a high quality corporate bond using the guidance on determining fair value.
18. The responses to the ED indicated that the proposed amendment raised more complex issues than had been expected. The Board therefore decided to adhere to its original plan to address measurement issues only in the context of a fundamental review.
19. In 2012, the IFRS Interpretations Committee (Committee) received a request seeking clarification on the accounting for promises varying with asset returns. The Committee discussed possible approaches and measurement models, including:
  - (a) D9 (or similar) approach, which would require entities to measure benefits with a variable return at the fair value of the underlying reference assets and those with a fixed return using the projected unit credit method;
  - (b) fair value approach, which is consistent with the 2008 DP and would require entities to measure all benefit promises at fair value but excluding own credit risk;
  - (c) mirroring approach which would extend the requirement in paragraph 115 of IAS 19 to measure qualifying insurance policies at the present value of the related obligation; and

- (d) component approach which would require an entity to separate a defined benefit plan into a component measured as a defined contribution benefit, and a component measured as a defined benefit.

20. However, the Committee finally decided to remove the project from its agenda in May 2014, because it was difficult to find an appropriate scope for any exemptions from the current measurement in IAS 19.

*Research from other parties*

21. At the meeting of the Accounting Standards Advisory Forum in July 2018, the Canadian Accounting Standards Board presented the result of a research project which collected information on new types of pension plans with risk-sharing features across different jurisdictions. The report also included a description of possible ideas to explore in accounting for hybrid plans<sup>1</sup>.
22. The report showed that there is a broad diversity in the design of new plans and acknowledged that no single approach would be suitable to address all of them.
23. In May 2019, the European Financial Reporting Advisory Group (EFRAG) published a Discussion Paper *Accounting for Pension Plans with an Asset-return Promise*. The Discussion Paper (DP) explored alternative accounting treatments for post-retirement employee benefits promising the higher of the return on an identified item or group of items and a minimum guaranteed return (referred to as an ‘asset-return promise’). The scope of the DP was restricted to plans holding the reference assets.
24. The DP considered three alternatives for the measurement of the DBO of these plans:
- (a) a Capped Asset Return approach, which is close to the approach being explored in our project;
  - (b) a Fair Value Based approach; and

---

<sup>1</sup> See [July 2018 ASAF Agenda Paper 7](#).

(c) a Fulfilment Value approach, that relies on the concepts in IFRS 17 *Insurance Contracts* without being fully aligned to the requirements in IFRS 17.

25. The comment period for the EFRAG DP ended on 15 November 2019 and EFRAG has not yet discussed the results of its consultation. Most public responses express support for the Capped Rate Asset approach as a pragmatic solution to a specific issue and suggest modifying it into an approach where the expected returns are always matched with the rate used to discount the DBO. Respondents generally oppose the other two approaches, mostly on the grounds of cost and complexity.

### ***The approach being explored***

26. Following the 2015 Agenda Consultation, the Board added to its research pipeline a project to consider whether it would be feasible, without undertaking a comprehensive review of IAS 19, to eliminate an inconsistency in the measurement of pension benefits that depend on asset returns.
27. The Board agreed with the staff's recommendation that this investigation should focus solely on a "capped" ultimate costs adjustment model. Under the model, the projected cash flows that vary with the asset returns are capped so that they do not exceed the discount rate specified under IAS 19.
28. In a scenario where the expected rate of return on the reference assets is 5% and the discount rate specified by IAS 19 is 3%, applying the cap would result in the entity both projecting and discounting the benefits at 3%.
29. The cap would apply only to the benefits that vary with the level of returns on specified assets. If the plan provides other benefits, such as coverage of medical costs, these other benefits would be measured using the general requirements in IAS 19.

30. The approach would apply regardless of whether the reference assets are held by the plan. This is because the objective of the approach is to eliminate the internal inconsistency within the measurement of the DBO, not necessarily to eliminate differences between the measurement of the DBO and the measurement of the plan assets.
31. The approach has the following advantages:
- (a) it does not require identifying a sub-population of post-employment plans. The Committee and the Board have had several attempts to do this, without success. The approach automatically applies to the situations that cause the problem that it resolves;
  - (b) it would not change IAS 19 fundamentally;
  - (c) it would be consistent with the “net interest approach” in the current IAS 19, which requires an entity to use the discount rate to calculate the interest income on plan assets, even when the expected return on the plan assets is different from that discount rate;
  - (d) it would not be necessary to determine exactly which discount rate is most appropriate for post-employment benefits in general. The experience with the 2009 ED shows that it may be difficult to achieve a consensus on that issue; and
  - (e) it could be applied to plans that provide some benefits that vary with asset returns and other benefits that do not vary with asset returns.
32. The staff also recommended then that the investigation should focus solely on that approach. The staff stated that if that approach turns out not to be viable, the staff would recommend to the Board doing no further work on post-employment benefits in the 2017-2021 Agenda Cycle.
33. The Board noted in *IASB Work Plan 2017-2021*, its feedback statement on the 2015 Agenda Consultation, that it planned no other work on IAS 19. This was because the Board decided that there was no evidence of problems that were sufficiently widespread and significant to require a comprehensive review of IAS 19 in the 2017-2021 agenda cycle.



**Next steps**

34. In recommending to the Board in 2015 that it should include this project in its research pipeline, the staff recommended that the project should consist of analysis and outreach to investigate whether the approach can be developed in a way that:
- (a) would eliminate or reduce the accounting anomaly caused by the inconsistency between the cash flows for these benefits and the discount rate;
  - (b) would have sufficient effect to be worth the costs of developing, exposing, finalising and implementing any resulting changes to IAS 19;
  - (c) does not require a significant amount of work for stakeholders, the Board and the staff; and
  - (d) does not have unintended consequences.
35. In considering whether the approach might have unintended consequences, the staff will consider whether there may be interactions with other features of some pension plans. These include:
- (a) conditional indexation, under which benefits, or contributions are adjusted over time depending on the funding status of the plan;
  - (b) vesting conditions and in-service death benefits; and
  - (c) minimum guaranteed returns. These guarantees are either contractual or required by the law in some countries. Guarantees can apply at retirement only or can be ongoing (that is, at each point in time the assets must be equal to the contributions plus the guaranteed return). When a plan includes a guarantee, this could affect the application of the model because if the projected returns fall below the guarantee, then the benefits no longer depend on the asset returns.
36. The staff is currently developing illustrative examples to compare the accounting outcome under the existing requirements and under the “capped” ultimate costs adjustment model. This also allows to identify possible practical issues in the application of the model.

- 37. The staff has also asked for informal input from the actuarial profession to ensure that the examples reflect realistic terms and conditions.
- 38. We are also updating the data that was presented in November 2015 on global trends in pensions<sup>2</sup>. The objective of the data collection is to help the board decide whether to pursue an amendment to IAS 19 for benefits that vary with asset returns. However, it is unlikely that we will be able to collect comprehensive information on this type of benefits. Most available statistics categorise occupational plans at a higher level (for instance into “traditional DB plans”, “DC plans” and “hybrids”).
- 39. The staff expects to complete the illustrative examples and the data collection by the end of Q1 2020 and to bring the results to a Board session in Q2.

**Question to the Board**

Do Board members have questions or comments on this paper?

---

<sup>2</sup> See [November 2015 Agenda Paper 15A](#).