IFRS

# STAFF PAPER

November 2021

**IASB® Meeting**

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| **Project** | **Second Comprehensive Review of the *IFRS for SMEs*® Standard** | | |
| Paper topic | Towards an Exposure Draft—Simplifications permitted by paragraph 28.19 | | |
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## Introduction

1. This paper discusses whether to propose removing or amending paragraph 28.19 of the *IFRS for SMEs* Standard, which provides simplifications to the measurement of defined benefit obligations.

2. In this paper, the term SMEs refers to small and medium-sized entities that are eligible to apply the *IFRS for SMEs* Standard.

## Purpose of the paper

3. The purpose of this paper is to ask the International Accounting Standards Board (Board) to:

   (a) consider feedback on the Request for Information *Comprehensive Review of the* IFRS for SMEs *Standard*, published in January 2020;

   (b) consider the recommendations of the SME Implementation Group (SMEIG) on applying paragraph 28.19; and

   (c) decide whether to propose removing or amending paragraph 28.19.

## Structure of the paper

4. This paper is structured as follows:

   (a) background (paragraphs 5–10);

   (b) questions in the Request for Information (paragraph 11);

   (c) feedback from comment letters (paragraph 12);

   (d) SMEIG recommendations (paragraphs 13–15);

   (e) staff analysis and recommendations (paragraphs 16–46); and

   (f) questions for the Board.

## Background

5. Section 28 of the *IFRS for SMEs* Standard requires an SME to use the projected unit credit method to measure its defined benefit obligation and the related expense if the SME is able to do so without undue cost or effort.

6. Paragraph 28.19 of the *IFRS for SMEs* Standard states:

> If an entity is not able, without undue cost or effort, to use the projected unit credit method to measure its obligation and cost under defined benefit plans, the entity is permitted to make the following simplifications in measuring its defined benefit obligation with respect to current employees:
>
> (a) ignore estimated future salary increases (ie assume current salaries continue until current employees are expected to begin receiving post-employment benefits).
>
> (b) ignore future service of current employees (ie assume closure of the plan for existing as well as any new employees).
>
> (c) ignore possible in-service mortality of current employees between the reporting date and the date employees are expected to begin receiving post-employment benefits (ie assume all current employees will receive the post-employment benefits). However, mortality after service (ie life expectancy) will still need to be considered.

An entity that takes advantage of the foregoing measurement simplifications must nonetheless include both vested benefits and unvested benefits in measuring its defined benefit obligation.

7. The purpose of paragraph 28.19, when it was developed, was to retain the IAS 19 measurement principles but reduce the need to engage external specialists.[1]

8. The Board asked a question in the Request for Information about how the simplifications permitted by paragraph 28.19 are applied because it had received a question on application of the paragraph before the Second Comprehensive Review.

9. The feedback from some stakeholders is that it is unclear how to apply paragraph 28.19. For example, a stakeholder asked whether the application of paragraph 28.19, in particular paragraph 28.19(b), requires an entity to discount the defined benefit obligation when the defined benefit plan pays a lump sum at the date of retirement (for example, a portion of the final year's salary multiplied by the number of years in service).

10. Some stakeholders asked whether paragraph 28.19:

    (a) requires an SME to apply all the simplifications if the SME chooses to take advantage of paragraph 28.19; or

    (b) if an SME can choose one or two of the simplifications in paragraph 28.19.

## Questions in the Request for Information

11. The Request for Information asked whether respondents are aware of:

    (a) entities applying the simplification permitted by paragraph 28.19 of the *IFRS for SMEs* Standard; and

    (b) difficulties arising in applying paragraph 28.19.

[1] Paragraph BC125 of the Basis for Conclusions on the *IFRS for SMEs* Standard.

## Feedback from comment letters

12. Some respondents said they are aware of entities applying the simplifications permitted by paragraph 28.19, and approximately half of these respondents are aware of difficulties arising in applying paragraph 28.19. For example:

    (a) RSM Eastern Africa commented:

    > While 28.19 is explicit about what can be ignored, it is not explicit as to whether cash flows have still to be projected and discounted, and we understand that there are differences in application. In our jurisdiction the most common method of estimating the liability is to calculate the amount that would have been payable had the employee retired at the reporting date (but including unvested amounts), which seems to us the simplest approach. Clarification that this approach is acceptable would be appreciated. In our view, it would be illogical to have to discount projected future cash flows whilst ignoring future salary increases.

    (b) Saudi Organization for Certified Public Accountants commented:

    > We have received numerous inquiries about the meaning of these simplifications, particularly simplification 28.19(b) when the defined benefit plan is in the form of a lump sum amount at the date of retirement (eg final salary multiplied by the number of years of service, which is the mode of end of service in our jurisdiction and many others). Most entities interpret paragraph 28.19(b) by measuring their defined benefit obligation at the gross amount due to all of its employees assuming that all of them will retire at the reporting date. However, such interpretation will render paragraph 28.19(a) and (c) meaningless. Moreover, such amount will not be discounted even there is high probability that employees will continue to render their services for many more years. In a related matter, allowing the simplification in paragraph 28.19(a) while requiring discounting will result in underestimating the obligation at the reporting date as the factor that will increase the liability (growth rate) is ignored, whereas the factor that will reduce the liability (discount rate) is still applicable.

## SMEIG recommendations

13. Many SMEIG members said defined benefit plans are not common among SMEs in their jurisdictions and they noticed a trend for entities to move from defined benefit plans to defined contribution plans.

14. Two SMEIG members said the simplifications permitted by paragraph 28.19 are not commonly applied because entities use external specialists to estimate the defined benefit liability, who do so using the projected unit credit method without taking advantage of paragraph 28.19. One SMEIG member said paragraph 28.19 is not available in the UK and the Republic of Ireland.

15. SMEIG members generally agreed that applying paragraph 28.19 requires the defined benefit obligation to be discounted. In addition, two members said clarification is needed to avoid the confusion in applying paragraph 28.19.

## Staff's analysis and recommendations

16. In this agenda paper, the staff analyse how to address the concern, in particular:

    (a) alternative 1—clarify paragraph 28.19:

        (i) is discounting required after applying paragraph 28.19; and

        (ii) how does an SME apply paragraph 28.19(b)?

    (b) alternative 2—remove paragraph 28.19.

### *Alternative 1—clarify paragraph 28.19*

*Is discounting required after applying paragraph 28.19?*

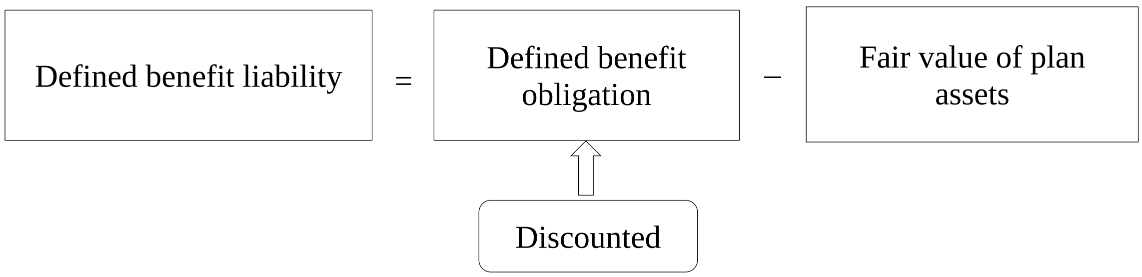
17. Paragraph 28.15 of the *IFRS for SMEs* Standard requires an SME to measure a defined benefit liability at the net total of the present value of its obligations under defined benefit

plans at the reporting date minus the fair value at the reporting date of plan assets out of which the obligations are to be settled directly.

18. The Glossary of Terms of the *IFRS for SMEs* Standard states:

- defined benefit liability — **the present value of the defined benefit obligation** at the reporting date minus the fair value at the reporting date of plan assets (if any) out of which the obligations are to be settled directly.
- defined benefit obligation (present value of) — the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.

19. The interrelationship between defined benefit liabilities and defined benefit obligations can be illustrated as:




20. The simplifications in paragraph 28.19 apply to the measurement of the defined benefit obligation, not the defined benefit liability or the present value of the defined benefit obligation.

21. Paragraph BC125(b) of the Basis for Conclusion on the *IFRS for SMEs* Standard states:

> If information based on the projected unit credit method is not available and cannot be obtained without undue cost or effort, SMEs must apply an approach that is based on IAS 19 but does not consider future salary progression, future service or possible mortality during an employee's period of service. This approach still takes into account life expectancy of employees after retirement age. The resulting defined benefit pension obligation reflects both vested and unvested benefits.

22. The staff could not see, in the Basis for Conclusion, the Board's intention to include a simplification that permits an SME not to discount the defined benefit obligation in deriving a defined benefit liability.

23. Therefore, in the staff's view, after applying paragraph 28.19 to the measurement of the defined benefit obligation (gross amount), an SME is required to discount the defined benefit obligation applying paragraph 28.15 and paragraph 28.17 of the *IFRS for SMEs* Standard.

24. That said, the staff acknowledge the interrelationship between defined benefit obligations and defined benefit liabilities is not always clear in Section 28 of the *IFRS for SMEs* Standard, for example the following paragraphs indicate that the defined benefit obligation itself is measured on a discounted basis rather than a gross amount:

    (a) paragraph 28.17:

    > An entity shall measure its defined benefit obligation on a discounted present value basis…

    (b) paragraph 28.18:

    > Additionally, the projected unit credit method requires an entity to make various actuarial assumptions in measuring the defined benefit obligation, including discount rates…

25. Therefore, to clarify whether discounting is required after applying paragraph 28.19, the Board could:

    (a) state explicitly in paragraph 28.19 that discounting is required after applying the simplifications permitted by paragraph 28.19; and

    (b) make changes to other paragraphs in Section 28 of the *IFRS for SMEs* Standard to clarify the interrelationship between defined benefit obligations and defined benefit liabilities.

*How does an SME apply paragraph 28.19(b)?*

26. Some respondents asked the Board to clarify how to apply paragraph 28.19, in particular the meaning of 'ignore future service of current employees' in paragraph 28.19(b).

27. The staff have identified two approaches to interpret paragraph 28.19(b) when an SME ignores future service:

    (a) wide interpretation; and

    (b) narrow interpretation.

***Wide interpretation***

28. The staff think paragraph 28.19(b) can be interpreted that an SME assumes all its employees end their employment at the end of the reporting period. Applying the wide interpretation of paragraph 28.19(b) an SME would ignore several assumptions, for example:

    (a) future salary increases;

    (b) in-service mortality;

    (c) the probability of employees not meeting the vesting conditions when the vesting conditions relate to future service (future turnover rate) (paragraph 29 of this agenda paper); and

    (d) the effects of benefit formulas that give employees greater benefits for later years of service (paragraph 30 of this agenda paper).

29. Vesting conditions of a defined benefit plan can relate to employees' years of service, for example an employee may only be entitled to the pension benefit upon completing five years of service. In this example, by ignoring future service, an SME ignores the probability of employees with less than five years of service not meeting the vesting condition. Section 28 of the *IFRS for SMEs* Standard requires an SME to include both vested benefits and unvested benefits in measuring its defined benefit obligation. Ignoring the probability assumes all the employees meet the vesting condition.

30. Some defined benefit plans assume pension benefits at a higher rate depending on the length of service, for example 1% of final annual salary for each year of service for the first ten years of service and 2% of final annual salary for each year of service for eleven and onwards years of service. In this example, by ignoring future service, an SME ignores the effect of higher benefits in later years of service.

31. A wide interpretation of paragraph 28.19(b) would suggest some of the assumptions that can be ignored applying paragraph 28.19(b) are the same as the assumptions that can be ignored applying paragraph 28.19(a) and 28.19(c). The wide interpretation of paragraph 28.19(b) would make paragraph 28.19(a) and 28.19(c) redundant. To address this duplication the Board could clarify that the simplification in paragraph 28.19(b) should not be applied together with the simplification in paragraph 28.19(a) or paragraph 28.19(c). However, the staff think this would complicate paragraph 28.19.

32. The staff note that the Module 28 of the *IFRS for SMEs* education modules states:

> If, without undue cost or effort, an entity is unable to use the projected unit credit method set out in paragraph 28.18 to measure its defined benefit obligation, the entity is permitted to apply **any of** the simplifications in paragraph 28.19 for measuring its defined benefit obligation.

33. In example 32 of Module 28 of the *IFRS for SMEs* Modules, the SME has used one of the simplifications, that is ignoring the future salary increases.

***Narrow interpretation***

34. A narrow interpretation of paragraph 28.19(b) avoids the duplication. A narrow interpretation of paragraph 28.19(b) would permit an SME to ignore only:

    (a) the probability of employees not meeting the vesting conditions when the vesting conditions relate to future service (future turnover rate); and

    (b) the effects of benefit formulas that give employees greater benefits for later years of service.

35. A narrow interpretation is consistent with Module 28 and it does not duplicate assumptions in paragraph 28.19(a) and 28.19(c).

36. In view of the consistency with the education modules the staff think the Board could clarify the narrow interpretation of paragraph 28.19(b); meaning an SME would be permitted to apply any or all of the simplifications in paragraph 28.19 when measuring its defined benefit obligation.

37. In summary, if the Board disagree with alternative 2 which is the staff's recommendation, the Board could:

    (a) clarify an SME may apply any, or all, of the simplifications permitted by paragraph 28.19 when measuring a defined benefit obligation;

    (b) clarify paragraph 28.19 applies to the measurement of defined benefit obligations therefore discounting is required after applying the simplifications; and

    (c) provide examples clarifying future services includes:

        (i) the probability of employees not meeting the vesting conditions when the vesting conditions relate to future service (future turnover rate); and

        (ii) the effects of a benefit formula that give employees greater benefits for later years of service.

### *Alternative 2—remove paragraph 28.19*

38. Even if the Board clarifies how to apply paragraph 28.19 a concern remains regarding paragraph 28.19 for example a respondent to the Request for Information noted:

> … allowing the simplification in paragraph 28.19(a) while requiring discounting will result in underestimating the obligation at the reporting date as the factor that will increase the liability (growth rate) is ignored, whereas the factor that will reduce the liability (discount rate) is still applicable.

39. Paragraph 28.16 of the *IFRS for SMEs* Standard states when using the projected unit credit method, an SME is required to use actuarial assumptions that are unbiased, mutually compatible and selected to lead to the best estimate of the future cash flows that will arise under the plan.

40. The staff think some of the inputs to the assumption for estimating future salary increase can overlap with some of the inputs to the discount rate assumption, for example the expected inflation rate could be an input to the estimate of future salary increases and the discount rate. The staff’s view is that applying the simplifications in paragraph 28.19 could be incompatible with the requirements in paragraph 28.16 and may not provide faithful representation of the present value of the defined benefit obligation.

41. The staff think, instead of clarifying the application of paragraph 28.19, the Board could consider removing the paragraph completely and thereby addressing the tension between paragraph 28.16 and paragraph 28.19.

42. The staff also note that responses to the Request for Information identified that paragraph 28.19 is not widely applied by SMEs when measuring defined benefit obligations.

43. As noted in paragraph 13 and 14 of this agenda paper, some SMEIG members commented that:

    (a) the defined benefit plans are not common in their jurisdictions and they noticed a trend for SMEs to move from defined benefit plans to defined contribution plans.

    (b) paragraph 28.19 is not commonly applied because SMEs that have defined benefit plans use external specialists to estimate the defined benefit liability. The external specialists make that estimation based on the projected unit credit method without using paragraph 28.19.

44. Removing paragraph 28.19 would disadvantage those SMEs that currently apply it. The impact may vary by jurisdiction—for example, by law, all entities in some jurisdictions are required to provide pension benefits to their employees. However, if the Board does not propose removing paragraph 28.19 but instead clarifies application of the paragraph based on the narrow interpretation, there may still be a cost for SMEs if they currently apply a different interpretation of paragraph 28.19, for example if they do not discount the defined benefit obligation after applying the simplifications as set out in paragraph 28.19.

45. The staff note that removing paragraph 28.19 might be contradictory with the simplicity principle. However, the staff think the benefit of improving faithful representation and reducing the options provided under the simplification exceeds the cost of reducing simplicity by removing paragraph 28.19.

46. In summary, the staff recommend the Board removing paragraph 28.19 of the *IFRS for SMEs* Standard.

| **Question for the Board** |
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| Does the Board agree with the staff's recommendation to remove paragraph 28.19 of the *IFRS for SMEs* Standard?<br><br>If the Board disagrees, does the Board agree to clarify paragraph 28.19 as set out in paragraph 37 of this agenda paper? |