Staff paper

Agenda reference: 30B

IASB® meeting

Date	**November 2023**
Project	**Second Comprehensive Review of the *IFRS for SMEs*® Accounting Standard**
Topic	**Simplification in paragraph 28.19**
Contact	Mostafa Mouit (mmouit@ifrs.org)

Purpose of this paper

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

   (a) consider feedback on the proposals in the Exposure Draft *Third edition of the* IFRS for SMEs *Accounting Standard* (Exposure Draft) to remove the simplification for measuring the obligation and the related cost of defined benefit plans in paragraph 28.19 of the *IFRS for SMEs* Accounting Standard (the Standard); and

   (b) decide whether to retain the simplification in paragraph 28.19 in the Standard, clarifying its application.

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

Staff recommendation

3. The staff recommend the IASB:

    (a) retains paragraph 28.19 of the Standard;

    (b) clarifies that, when applying paragraph 28.19, an SME measures a defined benefit plan obligation at the current termination amount—so that, an SME would assume all its employees terminate their employment at the reporting date and, therefore, it shall not discount its obligations from defined benefit plans; and

    (c) requires an SME to disclose the basis for determining that termination amount in (b).

Structure of this paper

4. The paper is structured as follows:

    (a) development of the proposals in the Exposure Draft (paragraphs 5–18 of this paper);

    (b) feedback on the proposals in the Exposure Draft (paragraphs 19–21 of this paper);

    (c) staff analysis (paragraphs 22–46 of this paper):

        (i) history of developing the simplification in paragraph 28.19 of the Standard (paragraph 24 of this paper); and

        (ii) retaining and clarifying the simplification in paragraph 28.19 of the Standard (paragraphs 25–46 of this paper); and

    (d) question for the IASB.

Development of the proposals in the Exposure Draft

Background and current requirements

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

6. Paragraph 28.19 of the 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 of the Standard, when it was developed, was to apply an approach that is based on the IAS 19 *Employee Benefits* but with simplification to reduce the need for SMEs to engage external specialists.

8. The IASB asked a question in the *Request for Information Comprehensive Review of the* IFRS for SMEs *Standard* (2020 Request for Information) on how the simplification in paragraph 28.19 of the Standard is applied in practice because it had received an application question seeking clarification on how to apply paragraph 28.19.

9. The submitter of the application question in paragraph 8 of this paper asked:

   (a) whether discounting is required when applying the simplification, as discounting the obligation under defined benefit plans while ignoring, for example, the estimated future salary increases can result in underestimating the obligation at the reporting date. This is because, the factor that increases the liability (salaries growth rate) is ignored; whereas the factor that reduces the liability (discount rate) is applied.

   (b) what the meaning of 'ignore future service' is in paragraph 28.19(b) of the Standard. The submitted asked for clarification on whether paragraph 28.19(b) permits an SME to measure its obligation for defined benefit plans at the undiscounted amount, assuming all employees retire at the reporting date. If so, then in the submitter's view:

      (i) discounting should not be required when applying that simplification.

      (ii) paragraphs 28.19(a) and (c) of the Standard are irrelevant.

10. The questions in paragraphs 9(a)–9(b) of this paper led to consequential questions on whether an SME when measuring the obligation and the related cost under defined benefit plans:

   (a) should apply all the simplifications in paragraph 28.19 of the Standard together; that is, as one bundle; or

   (b) may choose to apply any of those simplifications on an individual basis; for example, a mix-and-match.

Feedback from the 2020 Request for Information

Questions in the 2020 Request for Information

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

    (a) SMEs applying the simplification in paragraph 28.19 of the Standard; and

    (b) difficulties arising in applying paragraph 28.19.

Feedback from comment letters

12. Respondents said they are aware of SMEs applying the simplification in paragraph 28.19 of the Standard, and approximately half of those respondents are aware of difficulties arising in applying paragraph 28.19:

    (a) some said, while paragraph 28.19 is explicit about what can be ignored, it is not explicit as to whether cash flows should be projected and then discounted, which causes diversity in practice.

        They also said that most SMEs, when applying the simplification, estimate the obligation under defined benefit plans as the undiscounted amount that would have been payable had the employees retired at the reporting date (but including unvested amounts).

    (b) others said numerous inquiries had been raised in their jurisdiction on how to apply the simplification in paragraph 28.19(b) of the Standard.

SMEIG recommendations at its September 2021 meeting

13. Many SME Implementation Group (SMEIG) members said defined benefit plans are not common among SMEs in their jurisdictions, and they noticed a trend for SMEs to move from defined benefit plans to defined contribution plans.

14. Two SMEIG members said the simplification in paragraph 28.19 of the Standard is not widely applied because SMEs use external specialists to estimate the defined benefit liability. One SMEIG member said paragraph 28.19 is not available in the UK and the Republic of Ireland.

Proposals in the Exposure Draft

15. The IASB observed that the feedback on the 2020 Request for Information and the recommendations from the SMEIG:

    (a) provided evidence that only a few SMEs apply paragraph 28.19 of the Standard; and

    (b) suggested there is diversity in applying the simplification in paragraph 28.19, which results in diversity in measuring the obligation and the related cost under defined benefit plans amongst those a few SMEs.

16. Taking into consideration this feedback, the IASB proposed to remove the measurement simplification by deleting paragraph 28.19 of the Standard in the Exposure Draft.

17. However, in the Invitation to Comment on the Exposure Draft, the IASB noted that, because SMEs applied paragraph 28.19 of the Standard widely in some jurisdictions, if feedback on the Exposure Draft disagreed with the proposal to delete paragraph 28.19, it could consider retaining it and clarify how to apply the measurement simplification.

18. Therefore, the IASB asked, in the Invitation to Comment, whether the application of the measurement simplification in paragraph 28.19 of the Standard is limited and, therefore, whether it should delete paragraph 28.19 or, alternatively, whether it should:

    (a) clarify if an SME may use any, or all, of the simplifications in paragraph 28.19 when measuring the obligation and the related cost under defined benefit plans; and

    (b) explain that, when an SME applies paragraph 28.19(b) of the Standard, examples of future service of current employees that can be ignored include the probability of employees not meeting the vesting conditions when the vesting conditions relate to future service (future turnover rate); and the effects of a benefit formula that gives employees greater benefits for later years of service.

Feedback on the proposals in the Exposure Draft

Question 9—Proposed amendments to Section 28	
9(i)	Do you agree that only a few entities apply the measurement simplifications for defined benefits? Therefore, do you agree with the IASB's proposal to delete paragraph 28.19 of the Standard?
9(ii)	If you disagree with the proposal in 9(i), do you agree that this alternative approach clarifies paragraph 28.19 of the Standard?[1]

19. Respondents had mixed views on the IASB's proposal to delete paragraph 28.19 of the Standard. Many (a small majority) disagreed with the proposal to delete paragraph 28.19; whereas many (a large minority) agreed with the proposal:

(a) some of those respondents who disagreed with the proposal to delete paragraph 28.19 also disagreed that only a few SMEs apply the simplification.

The jurisdictions where SMEs take advantage of the simplification in paragraph 28.19 include East Africa, Kenya and Saudi Arabia. For example, one respondent said that, there are more than 100,000 SMEs in Saudi Arabia taking advantage of the simplification in paragraph 28.19.

(b) some of those respondents who agreed with the proposal to delete paragraph 28.19 also agreed that only a few SMEs apply it and said the simplification is either not available in their local GAAP version of the Standard (Sweden, UK and Ireland) or defined benefit plans are not common among SMEs (Brazil, Malaysia and Sri Lanka).

However, others in the same jurisdictions in paragraph 19(b) of this paper also said deleting paragraph 28.19 would result in higher actuarial costs for SMEs that apply the simplification.

[1] See paragraph 18 of this paper.

20. Most respondents who disagreed with the IASB's proposal to delete paragraph 28.19 of the Standard agreed that the alternative approach in Question 9(ii) of the Invitation to Comment would clarify paragraph 28.19, see paragraph 18 of this paper.

21. However, others said that the alternative approach in Question 9(ii) of the Invitation to Comment is not sufficient as it does not address the fundamental question of whether to discount the obligation from the defined benefit plan. They suggested the IASB should consider not requiring an SME to discount the obligation from a defined benefit plan in applying paragraph 28.19 of the Standard. They also said ignoring future salary increases and not discounting results in an amount that faithfully represents the obligation at the end of the reporting period; otherwise, the actuarial assumptions used by the SME:

    (a) would be mutually incompatible and therefore contradict paragraph 28.16 of the Standard (which states that the actuarial assumptions shall be unbiased, mutually compatible and selected to lead to the best estimate of the future cash flows that will arise under the plan); and

    (b) would not lead to a faithful representation of the obligation as at the reporting date.

Staff analysis

22. Paragraph BC125(b) of the Basis for Conclusion on the Standard explains that:

> 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.

23. The staff think that to assess whether to retain the simplification in paragraph 28.19 in the Standard, it would be useful to first review the history of developing the simplification in 2009. Notably, the staff could not see, in the Basis for Conclusion, whether discounting is required when applying the simplification.

History of developing the simplification in paragraph 28.19 of the Standard

24. By looking at the history of developing the simplification in paragraph 28.19 of the Standard, the staff observe that:
    (a) at its meetings in July and November 2008, the IASB considered, but did not support, staff proposals to measure defined benefit plan obligations at a current termination amount, defined as the vested benefit obligation at the reporting date, and asked the staff to bring back an approach that includes consideration of unvested benefits.
    (b) in January 2009, the IASB's Employee Benefits Working Group (EBWG) discussed possible simplifications at length. At its February 2009 meeting, the IASB discussed a number of possible simplifications that were based on the written comments and discussion of its EBWG members, see paragraph 26 of Agenda Paper 8: *Simplifying the approach for measuring an NPAE's cost and obligation under a defined benefit plan*.
    (c) at its February 2009 meeting, the IASB tentatively decided to permit an SME to measure the obligation of a defined benefit plan at the *current termination amount*, defined as the vested and unvested benefit obligation at the reporting date, assuming all employees were to terminate their employment as of that date using current salary information, and without, for example, projection of future salaries or employee turnover, and give disclosures, see IASB *Update* February 2009.

Retaining and clarifying the simplification in paragraph 28.19 of the Standard

Whether only a few entities apply paragraph 28.19?

25. The feedback on the proposals in the Exposure Draft provided evidence that the range of SMEs that apply paragraph 28.19 of the Standard differs according to jurisdictions and is typically driven by whether:
    (a) engaging external specialists results in SMEs incurring higher actuarial costs.
    (b) the simplification is available.
    (c) defined benefit plans are common among SMEs.

26. The staff observe that for respondents who supported the proposal to delete paragraph 28.19 of the Standard, the simplification is often not available in their jurisdictions and/or defined benefit plans are not common, or SMEs use external specialists to estimate the defined benefit liability. In other words, deleting or retaining paragraph 28.19 would not have a significant effect in those jurisdictions. However, some of those jurisdictions expressed some sympathy that deleting paragraph 28.19 would disadvantage those SMEs that take advantage of the simplification, even if they are a few.

27. That left the respondents who strongly disagreed with the proposal to delete paragraph 28.19 of the Standard, who also disagreed that only a few SMEs take advantage of the simplification in paragraph 28.19. The staff observe that in many jurisdictions where almost all SMEs apply the simplification in paragraph 28.19, those SMEs are required to provide post-employment benefits to their employees by law. Therefore, deleting paragraph 28.19 would have a significant effect on those jurisdictions. Those respondents also said deleting paragraph 28.19 would result in SMEs incurring higher actuarial costs in accounting for their defined benefit plans.

28. In the staff's view, considering paragraphs 25–27 of this paper, particularly the feedback from respondents in East Africa, Kenya and Saudi Arabia, there is sufficient evidence that the simplification in paragraph 28.19 of the Standard is applied by more than a few SMEs and, therefore, deleting paragraph 28.19 would have significant effects on those SMEs. Consequently, the staff recommend retaining paragraph 28.19 in the Standard.

Whether and why diversity in practice has emerged in applying the simplification in paragraph 28.19?

29. It appears that the diversity in practice has emerged in the application of the simplification in paragraph 28.19 of the Standard mainly because it is unclear:

    (a) whether discounting is required when applying the simplification; and

    (b) what is the meaning of 'ignore future service' in paragraph 28.19(b) of the Standard.

30. As noted in paragraph 24(c) of this paper, in developing paragraph 28.19 of the Standard, the IASB had intended an outcome that would measure the obligation and the related cost under defined benefit plans at the *current termination amount*, defined as the vested and unvested benefit obligations at the reporting date *assuming all employees were to terminate their employment as of that date* using current salary information, and without, for example, projection of future salaries or employee turnover.

31. The staff think that:

    (a) '…*current termination amount*…*assuming all employees were to terminate their employment as of the reporting date*…' is consistent with an approach that is based on IAS 19 and paragraphs 28.31–28.37 of the Standard, which set out requirements for termination benefits.

(b) the thought process in paragraph 31(a) of this paper:

    (i) is consistent with the IASB's rationale to reduce the need to engage external specialists;

    (ii) if applied, would avoid the need to clarify the meaning of 'ignore future service' in paragraph 28.19(b) of the Standard, because it assumes all employees terminate their employment at the reporting date, see paragraph 18(b) of this paper and question 9(ii) of the Invitation to Comment on the Exposure Draft; and

    (iii) if applied, would resolve the consequential application questions as to whether an SME may use any, or all, of the simplifications in paragraph 28.19 of the Standard, because it will clarify all the simplifications are to be applied collectively as one bundle, see paragraph 18(a) of this paper and question 9(ii) of the Invitation to Comment on the Exposure Draft.

Whether discounting is required when applying the simplification?

32. The staff observe that if the approach set out in paragraphs 30 and 31(a) of this paper is applied, discounting the obligations from defined benefit plans would depend, as set out in paragraph 28.37 of this Standard, on whether the retirement benefits are due more (or less) than twelve months after the end of the reporting period. For example:

(a) if the defined benefit scheme provides a lump sum payment on retirement (a one-off payment on retirement) or on termination of employment, then assuming all employees terminate their employment as at the reporting date the retirement benefits would be due less than twelve months after the end of the reporting period. Accordingly, an SME would not discount its obligations from that defined benefit plan; whereas

(b) if the defined benefit scheme provides a future annual pension (a yearly pension after retirement until the expected date of death), then assuming all employees terminate their employment as at the reporting date the retirement benefits would be payable over the expected future lifetime of the employee and, consequently, would be due more than twelve months after the end of the reporting period. Accordingly, an SME would discount its obligations from that defined benefit plan.

33. For the defined benefit schemes that provide a lump sum payment on retirement or on termination of employment, as set out in paragraph 32(a) of this paper, the staff observe that, the outcome of applying the termination benefits accounting on those schemes is consistent with the current practice for most of the jurisdictions that have such retirement plans and currently apply the simplification. Feedback from respondents in those jurisdictions said that:

(a) the most common simplified method of estimating the obligation under defined benefit plans is to calculate the amount that would have been payable had the employee retired at the reporting date based on the undiscounted amount due at that date.

(b) there is consensus among SMEs, users of financial statements and authoritative bodies about the appropriateness of ignoring discounting the obligations for those schemes.

34. The staff, therefore, think that, if the IASB were to retain paragraph 28.19 in the Standard and clarify that discounting is not required for those schemes that provide a lump sum payment on retirement in paragraph 32(a) of this paper, the benefits would outweigh the costs.

35. For the defined benefit schemes that provide a future annual pension, as set out in paragraph 32(b) of this paper, the staff observe that:

(a) the feedback on the 2020 Request for Information and the Exposure Draft provided evidence that those schemes are not common among SMEs;

(b) however, in a few jurisdictions, defined benefit schemes are a hybrid between lump sum payment on retirement and future annual pension; and

(c) although drawing lines between a lump sum payment on retirement and a future annual pension would be consistent with applying the termination benefits accounting in paragraph 28.37 of this Standard; however, in the staff's views, it would introduce unnecessary complexity into the Standard.

36. Therefore, the staff think that the IASB should answer the following question: *should an SME, applying paragraph 28.19 of the Standard, be permitted not to discount its obligations from defined benefit schemes that provide a future annual pension?*

Possible way forward

37. To answer the question in paragraph 36 of this paper, the staff have applied the alignment principles of simplicity and faithful representation—assessing costs and benefits.

38. Applying paragraph 28.19 of the Standard, an SME is permitted to ignore future salaries, future service and in-service mortality. Therefore, permitting the SME not to discount its obligations from defined benefit schemes that provide a future annual pension would (arguably) be an additional simplification.

39. The staff acknowledge that measurement of those schemes that provide a future annual pension is complex. For example, to discount its obligations, an SME would use a discount rate by referring to market yields on high-quality corporate bonds (or on government bonds if there is no deep market).

40. The staff:

    (a) understand that ignoring future salaries, future service and in-service mortality is a relief for SMEs; whereas, discounting the obligations would require an SME to project the timing of the payments in the future to determine which market yields on high-quality corporate bonds it would use.

    (b) observe that the inputs to the assumption for future salary increases can overlap with the inputs to the discount rate. For example, the inflation rate could be an input for future salary increases and the discount rate. In the staff's view, in this circumstance, the market yields on high-quality corporate bonds may not be a good approximation.

41. Therefore, applying the simplification in paragraph 28.19 of the Standard and discounting the pension obligations:

    (a) could be incompatible with the requirements in paragraph 28.16 of the Standard; and

    (b) could not provide a faithful representation of the obligation at the reporting date. It could result in an understating the obligation to pay pensions at the reporting date.

42. Consequently, when applying paragraph 28.19 of the Standard, not discounting obligations of those schemes that provide a future annual pension would not impede the faithful representation. Also, not discounting obligations of those schemes would address the tension between paragraphs 28.16 and 28.19 of the Standard.

43. As noted in paragraph 35 of this paper, those schemes that provide a future annual pension are not common among SMEs. However, because:

    (a) in a few jurisdictions, defined benefit schemes are hybrid and between lump sum payment on retirement and future annual pension; and

    (b) drawing lines between types of benefits would introduce unnecessary complexity into the Standard,

    in the staff's view, if the IASB were to retain paragraph 28.19 in the Standard and clarify that discounting is not required for those schemes that provide a future annual pension in paragraph 32(b) of this paper, the benefits would outweigh the costs.

Improvements to disclosure requirements

44. Paragraph 28.41(c) of the Standard states that an SME that applies the simplification in paragraph 28.19 of the Standard, shall disclose that fact and the reasons why using the projected unit credit method to measure its obligation and cost under defined benefit plans would involve undue cost or effort.

45. Considering paragraph BC157 on the basis for conclusions in the Standard, ie the broad principles for assessing disclosures based on users' needs, the staff think that disclosing the basis for determining the current termination amount would provide users with useful information. In the staff's view, it would provide users with information about:

    (a) short-term cash flows and obligations; and

    (b) measurement uncertainties.

Conclusion

46. Considering paragraphs 22–45 of this paper, in the staff's view, the IASB should:

    (a) retain paragraph 28.19 of the Standard;

    (b) clarify that, when applying paragraph 28.19, an SME measures a defined benefit plan obligation at the current termination amount—so that, an SME would assume all its employees terminate their employment at the reporting date and, therefore, it shall not discount its obligations from defined benefit plans; and

    (c) require an SME to disclose the basis for determining that termination amount in (b).

Question for the IASB

Question for the IASB
1. Do IASB members agree with the staff analysis in this paper? 2. If yes, does the IASB agree with the staff recommendation in paragraph 3 of this paper to: (a) retain paragraph 28.19 of the Standard; (b) clarify that, when applying paragraph 28.19, an SME measures a defined benefit plan obligation at the current termination amount—so that, an SME would assume all its employees terminate their employment at the reporting date and, therefore, it shall not discount its obligations from defined benefit plans; and (c) require an SME to disclose the basis for determining that termination amount in (b)?