STAFF PAPER

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Project	**2015 Agenda Consultation**		
Paper topic	Comments received on research project on post-employment benefits		
CONTACT(S)	Kan Hara	khara@ifrs.org	+44 (0)20 7246 6968

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Purpose

1. This paper summarises the feedback received on the research project on post-employment benefits in response to the International Accounting Standards Board's (the Board's) Request for Views *2015 Agenda Consultation* ('the RFV') and other outreach conducted as part of the Board's public agenda consultation process.

Structure of this paper

2. This paper is organised as follows:
   - (a) background;
   - (b) overview of comments received on the research project on post-employment benefits;
   - (c) overview of previous work on post-employment benefits; and
   - (d) staff analysis and recommendation.

Background

3. Paragraph A12 of the RFV states that:

The International Accounting Standards Board is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of International Financial Reporting Standards. For more information visit www.ifrs.org

> Previous work has established that existing requirements in IAS 19 *Employee Benefits* do not work well for some schemes that have some features of defined contribution schemes and some features of defined benefit schemes. This project is assessing whether a solution can be developed for these hybrid schemes without reconsidering the current accounting for defined benefit and defined contribution schemes. If not, a more fundamental reconsideration may be needed. The work on this project is at an early stage.

4. While the RFV did not ask a specific question about the research project on post-employment benefits, it asked a generic question about the relative importance and urgency of all research projects and also asked for any other views on those projects.

Overview of comments received on research project on post-employment benefits

5. As part of its agenda consultation process, the Board received comments on the research project on post-employment benefits. Those comments were received as:
   (a) responses to the RFV; and
   (b) responses to an online survey.
6. In addition, feedback was received from the Accounting Standards Advisory Forum ('ASAF') in December 2015. The ASAF was presented with a paper updating ASAF members on the status of the research project.

Responses to the RFV: High-level summary of feedback received

7. The Board received 119 comment letters in response to the RFV. Of these respondents, 59 rated the importance of this research project and another two respondents provided comments on this project without providing a rating. The other 58 respondents were silent on this project.
8. 13 (or 21 per cent) of respondents thought the project should be rated as having high importance, 21 (or 34 per cent) thought it should be rated with medium

importance and the remaining 25 (or 41 per cent) thought the project is of low importance. The urgency ratings were generally similar.

9. We have included in **Appendix A** a breakdown of importance ratings by stakeholder type and geographical region.

10. Of the respondents who ranked the project as having high or medium importance, 24 respondents provided project-specific comments. The key issues that were noted by these respondents included:

    (a) accounting issues for hybrid plans; and

    (b) the methodology for selecting a discount rate.

11. One respondent cautioned that the Board should consider any overlap of this research project with the project on the *Conceptual Framework* and the discount rate research project.

12. Of the respondents who ranked the project as having low importance, 13 respondents provided project-specific reasons:

    (a) they had not experienced any major implementation issues with IAS 19 *Employee Benefits*; and

    (b) the Board has limited resources and other projects are more important.

13. One standard-setter in Asia was concerned about potential divergence from US GAAP if the Board undertakes a comprehensive project to revise IAS 19.

Responses to the RFV: Stakeholders who rated the project as high or medium importance/urgency

14. As noted in the high-level feedback summary, slightly more than half of the respondents who commented on this project rate the project as of high or medium importance, including more than half of those commenting from:

    (a) accounting firms, accountancy bodies, actuarial firms or bodies and regulators and government agencies; and

    (b) Europe, North America and Global.

15. Key messages received from these stakeholders are as follows.

(a) Accounting issues for hybrid plans

16. 18 respondents thought that accounting issues for hybrid plans should be addressed as a priority. The respondents included five accountancy bodies, four standard-setters, four accounting firms, two preparers and industry organisations, one actuarial body, one user and one regulator. 10 of the respondents were from Europe, 5 were from the Global region and the remainder were from other regions.

17. Respondents are generally concerned that the application of the discount rate requirements in IAS 19 does not reflect the economic substance of such plans because it creates an inconsistency between the estimate of cash flows an entity will pay to its employees and the discount rate used to calculate the present value of the defined benefit obligation.

18. For example, one respondent said (emphasis added):

> **In our jurisdiction, there are currently a few pure defined benefit plans that are in existence. Hybrid type plans are in existence (for example, the pension may offer a guaranteed payment plus an increase which is subject to affordability). Significant application issues arise from having to discount the expected benefits using high quality corporate bond/ government bond rates.** Also there are plans that give the member the choice at retirement to take the value of contributions to the plan plus actual returns (pure defined contribution) or to buy into the defined benefit plan. Under the current definition, such plans need to be treated as defined benefit from day one. For both of these issues **there is significant concern about the resultant values that are accounted for and disclosed under IAS 19. Actuaries have been qualifying their IAS 19 valuation reports on the basis that they believe the resultant values are grossly misleading. Bigger deficits are being reflected when economically they do not exist.** (South African Institute of Chartered Accountants)

19. Another respondent said (emphasis added):

We have assigned a slightly higher priority to Post-employment Benefits (including Pensions) primarily because **we think that IAS 19 Employee Benefits does not cope well with hybrid retirement plans. We are aware that IOSCO is concerned that recent developments in employee benefit promises do not fit well within the existing accounting requirements and that the Board has also sought input from different countries. The more challenging issue is whether a cost-beneficial solution can be found for the hybrid schemes and how such a solution would interact with IAS 19.** This suggests to us that a medium priority/ medium urgency rating is appropriate. (Deloitte Touche Tohmatsu)

(b) Methodology for selecting a discount rate

20. Three respondents in Europe raised concerns about the discount rate currently used in IAS 19:

(a) The Swedish Financial Reporting Board and one industry organisation in Sweden expressed concern that the current requirements could lead to a situation in which two companies with identical pension commitments may have to use significantly different discount rates solely because a deep market in corporate bonds exists in one country but does not exist in another country. (IAS 19 requires a discount rate based on yields on high-quality corporate bonds if a deep market exists for such bonds, but where no deep market exists in such bonds, government bond yields are used.) [1]; and

(b) One respondent pointed out the need to address the conceptual issue of when a discount rate should reflect only the time-value of money and when a risk premium should also be considered.

(c) Other areas noted:

21. Other comments by respondents included:

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[1] As noted in paragraph C10, the Board issued an Exposure Draft *Discount Rate for Employee Benefits* in 2009. That proposal was driven by concerns similar to those expressed by the two Swedish respondents. That proposal would have eliminated the use of different rates by deleting from IAS 19 the requirement to use yields on government bonds. That project was unsuccessful.

(a) there is a need for a comprehensive and fundamental review of accounting for post-employment benefits because market transactions (such as buy-outs, buy-ins and longevity swaps), as well as ongoing funding requirements, have shown that in many instances the actual funding obligation is higher than the obligation recognised in accordance with IAS 19 (two respondents);

(b) the current requirements to consider expected future salary increases for which there are no contractually binding commitments might conflict with the definition of a liability, because the entity may not have a present obligation to increase those salaries(one respondent); and

(c) the accounting requirements for net interest on the net defined benefit liability and the prohibition of recycling of Other Comprehensive Income (OCI) (one respondent).

Responses to the RFV: Stakeholders who rated the project with low importance/urgency

22. As noted in the high-level feedback summary, slightly less than half of all respondents commenting on this project rate the project as of low importance. By stakeholder type, especially, more than half of standard-setters expressed this view. In addition, by geographical region, more than half of respondents in Asia and Oceania expressed this view.

23. Key messages received from these stakeholders are as follows.

(a) No major implementation issues with IAS 19

24. Seven respondents noted that they had not experienced any major implementation issues with IAS 19. The respondents included three standard-setters, two preparers and industry organisations and two accountancy bodies. Two of the respondents were from Africa, two from Asia, two from Europe and one from Latin America.

(b) Limited resources of the Board and the existence of other more important projects

25. One accounting firm and one accountancy body noted the issue of accounting for hybrid plans as an area of concern. However, these respondents and others rated the project as less important than other projects.

Feedback from online survey

26. As part of its agenda consultation process, the Board conducted an online survey.[2] The following tables show the ranking of the research project on post-employment benefits.

	User ranking	**Non-user** ranking	**Total**
High priority	10 (14 per cent)	15 (23 per cent)	25 (19 per cent)
Medium priority	31 (44 per cent)	29 (44 per cent)	60 (44 per cent)
Low priority	22 (32 per cent)	15 (23 per cent)	37 (27 per cent)
No opinion	7 (10 per cent)	7 (10 per cent)	14 (10 per cent)
Total	70 (100 per cent)	66 (100 per cent)	136 (100 per cent)

27. The messages received through the online survey are generally consistent with those received through the responses to the RFV.

28. Comments from users on this research project included:

    (a) there is a general trend away from defined benefit (DB) pension plans towards defined contribution (DC) plans, including intermediate steps such as hybrid plans, and so there is a need to address the accounting for such plans;

    (b) it is important to maintain good accounting standards for DB plans to convey key risk management information to plan sponsors;

[2] For further details of the online survey, see Agenda Papers 24C and 24D from the IASB meeting in April 2016.

Nevertheless, other users questioned whether more work is needed on DB plan accounting as DB plans were in decline;

(c) it is important to review the requirement to consider expected future salary increases for which there is no contractually binding commitment; and

(d) pension accounting is still too complex and existing disclosures are uninformative and inadequate.

29. Comments from non-users on this research project pointed out a need to:

(a) review accounting for hybrid plans;

(b) develop a clearly defined treatment, given the importance of pension liabilities for many businesses; and

(c) improve disclosures because current requirements are extensive, may not be relevant for all businesses and are not understandable for investors.

Feedback from ASAF

30. The staff provided a project update on the research project on post-employment benefits at the December 2015 ASAF meeting.

31. ASAF members generally supported continuation of this research project, taking account of trends in pensions. Some stated that the Board should consider broader topics, for example, the unit of account, net presentation, presentation of performance (recycling) and discount rates.

32. ASAF members explained that there were diverse views about accounting for new types of pension plans and diverse practices (for example, the approach in IFRIC Draft Interpretation D9 *Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions* is used in some jurisdictions), whereas some stakeholders might want to retain current practices.

33. Some thought that setting a narrower scope for the project might fail to address problems, because various new types of pensions will emerge, whereas others

stated that the Board should consider asset-liability correlations and/or setting a new classification for hybrid plans in IAS 19.

34. One ASAF member suggested that the Board should carry out a targeted review on issues that some constituents have rated as highly important (such as non-recycling of OCI and the accounting requirements for net interest on the net defined benefit liability (asset)).

Overview of previous work on post-employment benefits

35. In 2011, the Board issued an amended IAS 19. The objective was to provide investors and other users of financial statements with a much clearer picture of a company's current and future obligations resulting from the provision of defined benefit plans, and how these obligations will affect a company's financial position, financial performance and cash flows. Specifically, the amendments made improvements in various areas, including:

    (a) immediate recognition of defined benefit cost;

    (b) presentation; and

    (c) disclosure.

36. After issuing the amended IAS 19, the Board issued subsequent narrow-scope amendments to IAS 19 to address:

    (a) contributions from employees (issued in 2013); and

    (b) a regional market issue on discount rate (issued as part of *Annual Improvements to IFRSs 2012-2014 Cycle* in 2014).

37. In addition, in 2015 the Board issued an Exposure Draft to address remeasurement on a plan amendment, curtailment or settlement (proposed amendments to IAS 19) and the availability of a refund from a defined benefit plan (proposed amendments to IFRIC 14 *IAS 19—The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their interaction*).

38. During the past few years, the IFRS Interpretations Committee ('the Interpretations Committee') has also received many submissions on IAS 19 or IFRIC 14, as summarised in **Appendix B**.

39. In particular, the Interpretations Committee has spent considerable time dealing with the accounting for contribution-based promises and other hybrid plans that have features of both defined benefit (DB) plans and defined contribution (DC) plans. The Interpretations Committee observed that the accounting for these plans is an important issue, because they are part of a growing range of plan designs that incorporate features not envisaged when IAS 19 was first developed. In addition, these plans are becoming increasingly common across the globe.

40. In addition, in 2008-2009 EFRAG published *Financial Reporting of Pensions* and then a feedback statement on that paper, in which EFRAG noted problems with IAS 19 including:[3]

    (a) lack of compatibility between the current requirements in IAS 19 for the measurement of obligations to reflect unvested benefits and future salary increases, and the definition and recognition of liabilities in the current *Conceptual Framework*; and

    (b) the conceptual challenges presented by the net presentation of plan assets and defined benefit obligations in IAS 19.

Latest status of IAS 19 research project

41. As explained at the September 2014 Board meeting, the purpose of this research project is, given the changing nature of pension promises:

    (a) to identify a conceptually sound and robust model for accounting for post-employment benefits; and

    (b) to gather information about the trends in pension plans.

42. At the November 2015 Board meeting, the staff provided the Board with an update on this research project. Among other things, the project update included:

    (a) information about global trends in pensions; and

    (b) an indication of potential models that might address the issue of hybrid plans.

[3] 'The Financial Reporting of Pensions, January 2008' and 'The Financial Reporting of Pensions-Feedback and Redeliberations, November 2009', The European Financial Reporting Advisory Group (EFRAG).

Staff analysis

Next step

43. We do not think that the Board should undertake a comprehensive review of the accounting for post-employment benefits at this stage. This is based on our consideration of:

    (a) the feedback received (as summarised above);

    (b) available resources; and

    (c) the priority of other projects.

44. However, as outlined in the feedback, we think that constituents have expressed a clear view that there is a need to consider the accounting for hybrid plans. In the view of many respondents, IAS 19 fails to reflect the economic substances of such plans because it leads to an inappropriate inconsistency (an accounting mismatch) between the cash flows estimated for such plans and the discount rate applied to them. We have included a summary of the specific accounting issues for hybrid plans in **Appendix C**. We also understand that the use of hybrid plans is increasing across the globe.

45. We agree that the concerns expressed in the previous paragraph are valid. Accordingly, we think that the Board should continue to investigate whether it is feasible to develop a solution that would address the 'accounting mismatch' concern for hybrid plans without undertaking a comprehensive review of IAS19.

46. We discuss in **Appendix C** one approach that has some promise (a 'capped' ultimate costs adjustment model). That approach applies to benefits that vary with the level of returns on specified assets. For those benefits, a cap would be applied on the cash flows included in the measurement of the liability: the cash flows would reflect a return that does not exceed the discount rate applied to the liability.

47. We have not yet explored the model in detail, and so we recommend carrying out further analysis and outreach to investigate whether it 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 hybrid plans 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.

48. We believe that our further investigation should focus solely on that approach. If that approach turns out not to be viable, we would recommend to the Board doing no further work on post-employment benefits.

49. That approach is one of several models for hybrid plans presented to the Board in November 2015. We recommend not pursuing the other models, for reasons summarised in **Appendix D**.

50. We think the Board should not carry out further research on other aspects of accounting for post-employment benefits.

Post-implementation Review of IAS 19

51. The Board could consider undertaking a post-implementation review (PIR) of IAS 19. The Board's Due Process Handbook requires that a PIR is undertaken after two years of implementation of a new IFRS Standard or a *major* amendment. As described in paragraph 35, the Board issued an amendment to IAS 19 in 2011.

52. Our view is that this amendment was not a 'major' amendment, and so we do not think that a PIR is mandatory. Nonetheless, the Board could choose to undertake a PIR if it thought that this would provide it with further information to help it determine the need for, and scope of, future work on this project. Generally, a PIR can be particularly helpful for obtaining a broad assessment of the range and nature of issues with an IFRS Standard.

53. Nonetheless, we think that the information that the Board already has, through the feedback on the agenda consultation, and the work it and the Interpretations Committee has already undertaken on a range of issues, gives it a broad overview

of the issues. Consequently we do not recommend that the Board undertakes a PIR of IAS 19.

Staff recommendation

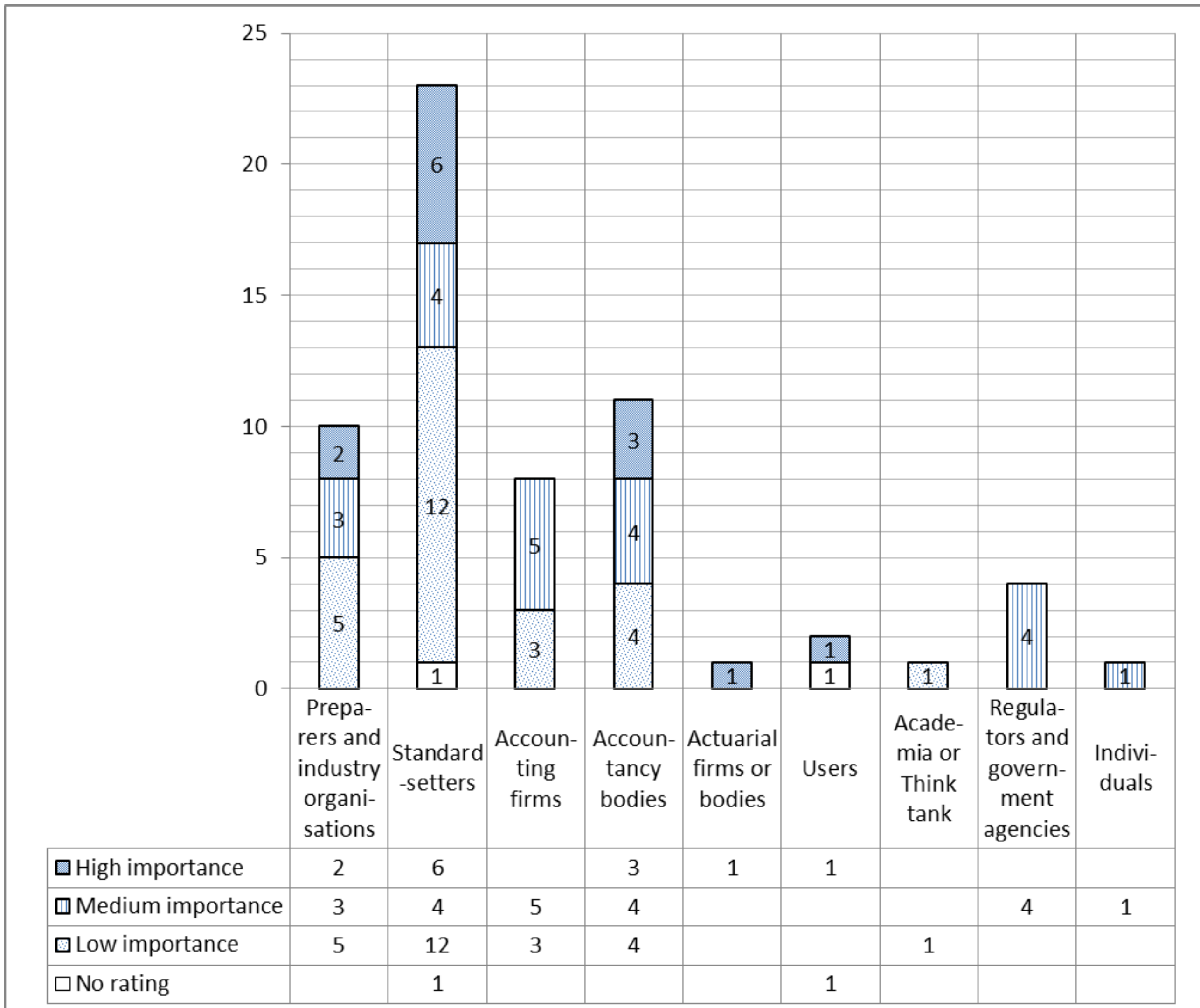
54. We recommend that the Board should investigate whether it is feasible to develop a solution to address the ‘accounting mismatch’ concern for hybrid plans without undertaking a comprehensive review of IAS 19. That investigation should focus solely on a ‘capped’ ultimate costs adjustment model presented at the November 2015 IASB meeting that:
    - (a) applies to solely benefits that vary with the level of returns on specified assets; and
    - (b) places a cap on the cash flows included in the measurement of the liability: the cash flows for those benefits would reflect a return that does not exceed the discount rate applied to the liability.
55. We also recommend that the Board does not undertake a PIR of IAS 19.

Question for the Board

Question for the Board
Does the Board agree with the staff recommendation in paragraph 54–55?

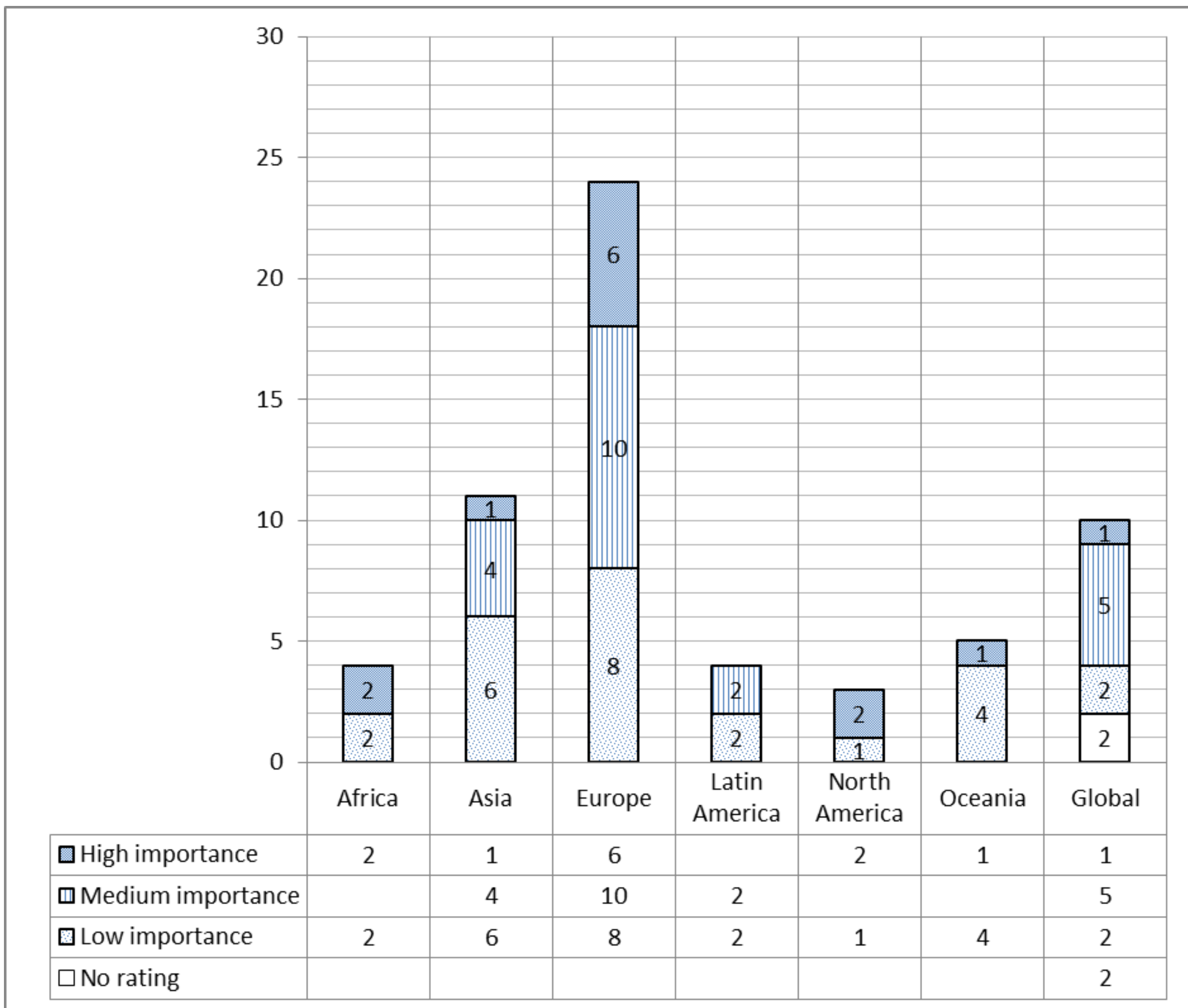
Appendix A—Breakdown of importance ratings by stakeholder type and geographical region.

***Chart1:** Importance ratings by stakeholder type*



	Preparers and industry organisations	Standard-setters	Accounting firms	Accountancy bodies	Actuarial firms or bodies	Users	Academia or Think tank	Regulators and government agencies	Individuals
High importance	2	6		3	1	1			
Medium importance	3	4	5	4				4	1
Low importance	5	12	3	4			1		
No rating		1				1			

Chart2: *Importance ratings by geographical region*



	Africa	Asia	Europe	Latin America	North America	Oceania	Global
High importance	2	1	6		2	1	1
Medium importance		4	10	2			5
Low importance	2	6	8	2	1	4	2
No rating							2

Appendix B—IAS 19 or IFRIC 14-related items discussed in the Interpretations Committee meetings after the revision of IAS 19 in 2011

Issues rejected—too broad to address
IAS 19: Actuarial assumptions—discount (November 2013)
The Interpretations Committee was asked to clarify whether corporate bonds with a rating lower than 'AA' can be considered to be high quality corporate bonds for the purposes of calculating the defined benefit obligation for post-employment benefits. The Interpretations Committee noted 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. Consequently the Interpretations Committee decided not to add this issue to its agenda.
IAS 19: Employee benefits plans with a guaranteed return on contributions or notional contributions (May 2014)
The Interpretations Committee received a request to clarify the accounting for contribution-based promises under IAS 19. Contribution-based promises are a post-employment benefit promise by which the amount of benefits to be received by the employee depends on the contributions plus a promised return. The Interpretations Committee discussed this issue in several meetings. However, it was unable to reach a consensus in identifying a suitable scope for an amendment. Consequently, the Interpretations Committee decided to remove this issue from its agenda. In the Interpretations Committee's view, developing accounting requirements for these plans would be better addressed by a broader consideration of accounting for employee benefits. The Interpretations Committee noted the importance of this issue because of the increasing use of these plans.
Issues rejected—sufficient guidance exists
IAS 19: Pre-tax or post-tax discount (July 2013)
The Interpretations Committee was asked to clarify whether, in accordance with IAS 19 *Employee Benefits* (2011), the discount rate used to calculate a defined benefit liability should be pre-tax or post-tax. The Interpretations Committee observed that the discount rate used to calculate a defined benefit obligation should be a pre-tax discount rate and decided not to add this issue to its agenda.
IFRIC 14: Should an entity assume continuation of a minimum funding requirement for contributions relating to future service? (July 2014)
The Interpretations Committee received a request to clarify whether the future minimum funding requirement for contributions to cover future service would apply for only the fixed period that had been agreed between the entity and the pension trustees. On the basis of its analysis, the Interpretations Committee determined that sufficient guidance exists. Consequently, it decided not to add this issue to its agenda.

IAS 19: Should longevity swaps held under a defined benefit plan be measured at fair value as part of plan assets or on another basis as a qualifying insurance policy? (March 2015)

The Interpretations Committee received a request to clarify the measurement of longevity swaps held under an entity's defined benefit plan in IAS 19.

On the basis of this analysis, the Interpretations Committee concluded that it did not expect diversity in the application of IAS 19 to develop and it therefore decided not to add this issue to its agenda.

Completed work

Narrow-scope amendments to IAS19: Defined Benefit Plans: Employee Contributions (November 2013)

The objective of this project was to provide additional guidance to IAS 19 on the accounting for contributions from employees or third parties set out in the formal terms of a defined benefit plan.

The narrow scope amendments apply to contributions from employees or third parties to defined benefit plans and have simplified the accounting for contributions that are independent of the number of years of employee service, for example, employee contributions that are calculated according to a fixed percentage of salary.

Annual Improvements 2012-2014 Cycle: IAS 19—Discount rate: regional market issue (September 2014)

The Board was asked to clarify the requirements of IAS 19 to determine the discount rate in a regional market sharing the same currency (for example, the Eurozone). The issue arose because some think that the basket of high quality corporate bonds should be determined at a country level, and not at a currency level.

The Board amended 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.

Work in progress

IFRIC 14: Availability of refunds from a defined benefit plan

The Interpretations Committee received a request to clarify the application of the requirements of IFRIC 14 regarding the availability of refunds from a defined benefit plan.

The Board issued an Exposure Draft in 2015 to address whether other parties' (for example, pension trustees) power to enhance benefits for plan members or wind up a plan affects the availability of a refund.

IAS 19: Remeasurement on a plan amendment, curtailment or settlement

This issue related to the calculation of current service cost and net interest when an entity remeasures the net defined benefit liability (asset) in the event of a plan amendment, curtailment or settlement.

The Board issued an Exposure Draft in 2015 to address the accounting when a plan amendment, curtailment or settlement occurs during a period.

Appendix C—Summary of the specific issues relating to the accounting for hybrid plans

C1 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. IAS 19 defines a DC plan as a post-employment plan under which an entity pays specified contributions into a separate entity (a fund) 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.

C2 If a post-employment plan is not a DC plan, it is a DB plan and an entity must estimate the present value of 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 'projected unit credit method'. An entity calculates the present value of the defined benefit obligation (DBO), discounted by bond rates in accordance with paragraphs 83-86 of IAS 19.

C3 An entity determines the deficit or surplus as the difference between the present value of the DBO and the fair value of 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 an asset ceiling.)

C4 When applying IAS 19, two particular issues arise in accounting for hybrid plans:

(a) an inconsistency between the cash flows and the discount rate (see paragraphs C5-C14); and

(b) a failure to account for the time value of economic exposures similar to those created by options (see paragraph C15-C17).

Inconsistency between cash flows and discount rate

C5 For some hybrid plans, the benefits paid to employees depend, wholly or partly, on the return on a specified pool of assets. Applying IAS 19, an entity projects the benefit on the basis of an assumption of future performance of the specified assets. That return is often assumed to be higher than bond rates. However, the discount rate to calculate the present value of DBO is generally a high quality

corporate bond rate as required in IAS 19. The plan assets are measured at fair value as at the end of each period.

C6 The following example illustrates the issue. (The example is highly simplified to focus on the features relevant to this discussion.) Suppose that:

(a) a plan will pay a benefit in one year equal to the fair value of specified assets in one year;

(b) the fair value of those assets today is CU100;

(c) current market interest rates for one year zero coupon instruments are 5% for a risk-free instrument and 5.8% for the bonds used to determine the discount rate under IAS 19; and

(d) the entity estimates that the fair value of the assets in one year will be CU108 (an assumed return of 8%). Thus, the entity estimates that it will pay employees a benefit of CU108 at that date. (If the fair value of the assets in one year is higher or lower than CU108, the amount paid will be that higher or lower amount.)

C7 When applying IAS 19, the entity estimates the cash flows at CU108, and discounts them at 5.8%, resulting in DBO measured at CU102. 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 will actually be held by the plan. In this example, if the plan does actually hold the reference assets, the entity will report a pension liability of CU2 (CU102 –CU100), even though it will never pay employees any amount above the fair value of those assets. (Note, however, that the inconsistency in (a) arises regardless of whether the plan actually holds the reference assets.)

C9 There are two ways of eliminating the inconsistency described in the previous paragraph:

(a) by correcting the discount rate; or

(b) by correcting the cash flows.

C10 In our view, it is not feasible to find a quick solution by correcting the discount rate. Any such solution would involve either:

(a) changing the discount rate for all post-employment liabilities. This would be likely to require extensive analysis, and could not be done without also considering interactions between the discount rate and other aspects of IAS 19—such as the treatment of future salary increases. Indeed, the Board tried in 2009 to make one quick fix to the discount rate in its Exposure Draft *Discount Rate for Employee Benefits*, but that project was unsuccessful; or

(b) identifying a sub-population of post-employment liabilities for which a different discount rate would be used. The Interpretations Committee and the Board have had several attempts to do this, without success.

C11 The other way to eliminate—or minimise—the inconsistency noted in paragraph C7 is to adjust the cash flows. We believe that this approach (a 'capped' ultimate costs adjustment model presented at the November 2015 IASB meeting) may be feasible. The approach would:

(a) apply only to asset-dependent employee benefits—those benefits that vary with the level of returns on specified assets (the reference assets). If a plan provides some benefits that vary and some that do not, it would apply only to the asset-dependent benefits;

(b) apply regardless of whether the plan actually holds the reference assets; and

(c) be applied in such a way that for the asset-dependent benefits, the estimate of cash flows would not exceed those produced by a return equal to the discount rate used to determine the present value of the DBO. In the above example, the estimate of cash flows would, therefore, be limited to CU105.8 (=CU100 *1.058). Discounting those cash flows at 5.8% over one year would produce a present value of CU100, equal to the fair value of the reference assets.

C12 In our view, this approach is promising, for the following reasons:

(a) it would not need an arbitrary scope to be set: it automatically applies to the situations (asset-dependent employee benefits) that cause the problem that it resolves;

(b) it would not change the fundamental requirements in IAS 19;

(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; and

(d) it would not be necessary to determine exactly which discount rate is most appropriate for post-employment benefits in general. For instance, in the above example, it is not necessary to determine whether the most appropriate rate for post-employment benefits is risk-free (5% in the example), a bond rate (5.8%) or some other rate. All the approach in the example does is to eliminate the difference between the rate used to estimate the cash flows (8% under IAS 19) and the discount rate (5.8%).

C13 Some may feel that adjusting the cash flows is a somewhat artificial exercise. It is worth remembering that this is an approach often used in pricing and valuing derivatives. The important thing is that the approach used to determine cash flows is consistent with the approach used to determine the discount rate. In the above example, the fair value of the assets can be determined in two ways that are mathematically equivalent. The ‘real world’ cash flows of CU108 can be discounted at a real world rate of 8%, or the ‘certainty equivalent’ cash flows of CU105 can be discounted at 5%. Practitioners can use either approach, depending on which is easiest to apply in the particular situation.

C14 The approach being explored by us is a slight extension of this idea. That extension is needed because, unless we do considerable extra research, we are not in a position to specify what the most appropriate discount rate is for post-employment benefits generally. This approach enables us to avoid doing that.

Time value of economic exposures similar to those created by options

C15 Some hybrid plans include a ‘higher of benefits’ feature, where the employee is guaranteed the higher of two or more possible outcomes (for example, the employer may guarantee the higher of a fixed return and the actual return on a specified pool of assets). Economically, that feature behaves like an option. For example, it may be modelled as a combination of the fixed return and a call option for the employees to receive specified pool of assets, for a strike price equal to the proceeds of the fixed return.

C16 When measuring the DBO under IAS 19, an entity must use its best estimates of the variables. The term ‘best estimate’ is often understood to be an estimate of a single outcome, not a weighted average reflecting different outcomes across various possible scenarios. Thus, although the intrinsic value of the option can be reflected in measuring the DBO when the expected return on the assets is considered to be higher than the fixed return as the single best estimate, this method cannot incorporate the time value of the option embedded in the ‘higher of’ feature.

C17 We think that the IAS 19 model would need to be fundamentally reconsidered in order to reflect the time value of these economic exposures. For example, one option could be to explore bifurcating these exposures as embedded derivative from the host DB promise and separately measuring them at fair value. However, this would result in significant changes to the measurement of the DBO under IAS 19 and would introduce significant complexity.[4] Therefore, we do not recommend any action on the ‘higher of benefits’ issue at this stage.

[4] This accounting treatment was proposed in the 2008 Discussion Paper *Preliminary Views on Amendments to IAS 19 Employee Benefits* but the past comments on the Discussion Paper implied that this treatment would introduce significant complexity for prepares.

Appendix D—Other approaches considered but not recommended

D1. We have summarised below other approaches (other than the 'capped' ultimate costs model discussed in Appendix C) that have been considered as a way of addressing the accounting issues relating to hybrid plans. We have also outlined our reasons for recommending that these approaches should not be pursued further at this stage:

(a) the current IAS 19 model;

(b) a fair value model;

(c) a customised fulfilment value model;

(d) the D9 model;

(e) a bifurcation model; and

(f) a mirroring model;

The current IAS 19 model

D2. Under this model, the projected unit credit method of IAS 19 is used to measure the obligation.

D3. As explained in paragraph C7, we think that for some hybrid plans, this results in a mismatch between (a) estimates made of employee benefits that vary with returns on specific plan assets and (b) discount rates based on (usually lower) high quality corporate bond rates. This might mislead users of financial statements.

A fair value model

D4. Under this model, which was proposed in the 2008 Discussion Paper, liabilities for contribution-based promises would be measured at fair value. If the employee is guaranteed the higher of two or more possible outcomes (eg the higher of a fixed return and the actual return of plan assets), this 'higher of benefits' option would be accounted for separately from a host DB promise and measured at fair value. The host DB promise would be measured by the IAS 19 model.

D5. We think that fair value is not the best solution for pension accounting because the entity usually fulfils the liability rather than transferring it to another party and the separate accounting for the 'higher of benefits' option as explained in **Appendix C** would be too complex.

A customised fulfilment value model

D6. Under this model, which is aligned with the Board's new approach to measuring insurance contracts, measurement for an obligation would include a current, unbiased estimate of the cash flows expected to fulfil the obligation, an adjustment for the time value of money and an adjustment for the effects of risk and uncertainty.

D7. We think that a customised fulfilment value model could be conceptually appropriate for pension accounting, considering some similarities between pension promises and insurance contracts. We also think that through the adjustment for the time value of money and the effects of risk and uncertainty, the model would reflect the characteristics of the cash flows (ie it would reflect the dependence on the asset returns of the underlying reference assets) and the value of 'higher-of benefits' option would be appropriately reflected.

D8. We are concerned, however, that the model would result in significant changes to the IAS 19 model and could introduce significant complexity. It would require undertaking a large-scale research project that would require a significant investment of resources.

The D9 model

D9. This model was proposed in 2004 as IFRIC Draft Interpretation D9. Under this model, an entity is required 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. Furthermore, an entity would measure the 'higher of benefits' option at the intrinsic value.

D10. While we acknowledge that this model could be an improvement to the current model in IAS 19, we note that the Interpretations Committee was unable to reach a consensus on a suitable scope for this model. We continue to think that it

would be very difficult to set an appropriate scope for the D9 model and do not recommend pursuing this option further.

Bifurcation model

D11. Under this model, a contribution-based promise would be separated into a DC component and a component for any guaranteed return. The guaranteed return would be measured at fair value by option pricing or some other methodology. The Board considered this model in developing the fair value model in the 2008 Discussion Paper, but rejected it because it would mix different measurement bases for one obligation and might provide opportunities for accounting arbitrage.

D12. We think that the bifurcation model might provide more useful information for DC plans with guaranteed promises, compared to the current accounting for DC plans in IAS 19 which ignores the values of guarantees. However, we share the same concern that had been noted by the Board previously, namely that any approach that measured the liability for the DC component differently from the guaranteed return could lead to the same economic obligation being accounted for differently.

Mirroring model

D13. Under this model, the fair value of the plan assets would be the present value of the related obligations for some hybrid types of pensions.

D14. We think that a merit of this model is that it would cause the amount of the obligation to match the amount of the fair value of plan assets, when the matching strategy between the obligation and the plan asset works correctly. However, we think that considering recent discussions at the Interpretations Committee, setting an appropriate scope for the different measurement bases would be challenging and we do not think that this can be applied to all problematic hybrid plans.