IFRIC Update April 2021

IFRIC *Update* is a summary of the decisions reached by the IFRS Interpretations Committee (Committee) in its public meetings. Past *Updates* can be found in the IFRIC *Update* archive.

The Committee met on 20 April 2021, and discussed:

Agenda decisions for Board consideration

- Attributing Benefit to Periods of Service (IAS 19 *Employee Benefits*)—Agenda Paper 2
- Hedging Variability in Cash Flows due to Real Interest Rates (IFRS 9 *Financial Instruments*)—Agenda Paper 4

Other matters

- Classification of Debt with Covenants as Current or Non-current (IAS 1 *Presentation of Financial Statements*)—Agenda Paper 3
- Work in Progress—Agenda Paper 5

Addendum to IFRIC Update—Committee's agenda decisions

- Attributing Benefit to Periods of Service (IAS 19 *Employee Benefits*)—Agenda Paper 2
- Hedging Variability in Cash Flows due to Real Interest Rates (IFRS 9 *Financial Instruments*)—Agenda Paper 4

Related information

The work plan

Supporting consistent application

Agenda decisions for Board consideration

Attributing Benefit to Periods of Service (IAS 19 *Employee Benefits*)—Agenda Paper 2

The Committee considered feedback on the tentative agenda decision published in the December 2020 IFRIC *Update* about the periods of service to which an entity attributes benefit for a particular defined benefit plan.

The Committee reached its conclusions on the agenda decision. In accordance with paragraph 8.7 of the IFRS Foundation's *Due Process Handbook*, the Board will consider this agenda decision at its May 2021 meeting. If the Board does not object to the agenda decision, it will be published in May 2021 in an addendum to this IFRIC *Update*.

Agenda paper 2: Report to the Board

Respondents to the tentative agenda decision said paragraphs 70–74 of IAS 19 are not always clear about the principles to be applied when attributing benefit to periods of service for a defined benefit plan.

Hedging Variability in Cash Flows due to Real Interest Rates (IFRS 9 *Financial Instruments*)—Agenda Paper 4

The Committee considered feedback on the tentative agenda decision published in the December 2020 IFRIC *Update* about applying the hedge accounting requirements in IFRS 9 when the risk management objective is to 'fix' the cash flows in real terms.

The Committee reached its conclusions on the agenda decision. In accordance with paragraph 8.7 of the IFRS Foundation's *Due Process Handbook*, the Board will consider this agenda decision at its May 2021 meeting. If the Board does not object to the agenda decision, it will be published in May 2021 in an addendum to this IFRIC *Update*.

Other matters

Classification of Debt with Covenants as Current or Non-current (IAS 1 *Presentation of Financial Statements*)—Agenda Paper 3

The Committee considered feedback on the tentative agenda decision published in the December 2020 IFRIC *Update* about how an entity applies *Classification of Liabilities as Current or Non-current*, which amended IAS 1, to particular fact patterns.

The Committee confirmed its agreement with the technical analysis and conclusions in the tentative agenda decision. Nonetheless, before finalising the agenda decision, the Committee decided to report to the Board:

a. its technical analysis and conclusions on the matter; and
b. respondents' comments on the outcomes and potential consequences of applying the amendments, highlighting those that might provide information the Board did not consider when developing the amendments.

Next step

The Board will discuss the matter at a future Board meeting.

Work in Progress—Agenda Paper 5

The Committee received an update on the current status of open matters not discussed at its meeting in April 2021.

Addendum to IFRIC Update—Committee's agenda decisions

Agenda decisions, in many cases, include explanatory material. Explanatory material may provide additional insights that might change an entity's understanding of the principles and requirements in IFRS Standards. Because of this, an entity might determine that it needs to change an accounting policy as a result of an agenda decision. It is expected that an entity would be entitled to sufficient time to make that determination and implement any necessary accounting policy change (for example, an entity may need to obtain new information or adapt its systems to implement a change). Determining how much time is sufficient to make an accounting policy change is a matter of judgement that depends on an entity's particular facts and circumstances. Nonetheless an entity would be expected to implement any change on a timely basis and, if material, consider whether disclosure related to the change is required by IFRS Standards.

The Committee discussed the following matters and decided not to add standard-setting projects to the work plan.

Attributing Benefit to Periods of Service (IAS 19 *Employee Benefits*)—Agenda Paper 2

Published in May 2021[1]

The Committee received a request about the periods of service to which an entity attributes benefit for a particular defined benefit plan. Under the terms of the plan:

a. employees are entitled to a lump sum benefit payment when they reach a specified retirement age provided they are employed by the entity when they reach that retirement age; and
b. the amount of the retirement benefit to which an employee is entitled depends on the length of employee service with the entity before the retirement age and is capped at a specified number of consecutive years of service.

To illustrate the fact pattern described in the request, assume an entity sponsors a defined benefit plan for its employees. Under the terms of the plan:

a. employees are entitled to a retirement benefit only when they reach the retirement age of 62 provided they are employed by the entity when they reach that retirement age;
b. the amount of the retirement benefit is calculated as one month of final salary for each year of service with the entity before the retirement age;
c. the retirement benefit is capped at 16 years of service (that is, the maximum retirement benefit to which an employee is entitled is 16 months of final salary); and

[1] [In accordance with paragraph 8.7 of the *Due Process Handbook*, at its May 2021 meeting, the International Accounting Standards Board discussed, and did not object to, this agenda decision.]

d. the retirement benefit is calculated using only the number of consecutive years of employee service with the entity immediately before the retirement age.

Paragraphs 70–74 of IAS 19 require an entity to attribute benefit to periods of service under the plan's benefit formula from the date when employee service first leads to benefits under the plan until the date when further employee service will lead to no material amount of further benefits under the plan. Paragraph 71 requires an entity to attribute benefit to periods in which the obligation to provide post-employment benefits arises. That paragraph also specifies that the obligation arises as employees render services in return for post-employment benefits an entity expects to pay in future reporting periods. Paragraph 72 specifies that employee service before the vesting date gives rise to a constructive obligation because, at the end of each successive reporting period, the amount of future service an employee will have to render before becoming entitled to the benefit is reduced.

For the defined benefit plan illustrated in this agenda decision:

a. if an employee joins the entity before the age of 46 (that is, there are more than 16 years before the employee's retirement age), any service the employee renders before the age of 46 does not lead to benefits under the plan. Employee service before the age of 46 affects neither the timing nor the amount of the retirement benefit. Accordingly, the entity's obligation to provide the retirement benefit arises for employee service rendered only from the age of 46.
b. if an employee joins the entity on or after the age of 46, any service the employee renders leads to benefits under the plan. Employee service rendered from the date of employment affects the amount of the retirement benefit. Accordingly, the entity's obligation to provide the retirement benefit arises from the date the employee first renders service.

Paragraph 73 of IAS 19 specifies that an entity's obligation increases until the date when further service by the employee will lead to no material amount of further benefits under the plan. The Committee observed that:

a. each year of service between the age of 46 and the age of 62 leads to further benefits because service rendered in each of those years reduces the amount of future service an employee will have to render before becoming entitled to the retirement benefit.
b. an employee will receive no material amount of further benefits from the age of 62, regardless of the age at which the employee joins the entity. The entity therefore attributes retirement benefit only until the age of 62.

Consequently, for the defined benefit plan illustrated in this agenda decision, the Committee concluded that the entity attributes retirement benefit to each year in which an employee renders service from the age of 46 to the age of 62 (or, if employment commences on or after the age of 46, from the date the employee first renders service to the age of 62). The Committee's conclusion aligns with the outcome set out in the first part of Example 2 illustrating paragraph 73 (that is, for employees who join before the age of 35), which is part of IAS 19.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to determine the periods to which retirement benefit is attributed in the fact pattern described in the request. Consequently, the Committee decided not to add a standard-setting project to the work plan.

Hedging Variability in Cash Flows due to Real Interest Rates (IFRS 9 *Financial Instruments*)—Agenda Paper 4

Published in May 2021[1]

The Committee received a request about applying the hedge accounting requirements in IFRS 9 when the risk management objective is to 'fix' the cash flows in real terms.

The request asked whether a hedge of the variability in cash flows arising from changes in the real interest rate, rather than the nominal interest rate, could be accounted for as a cash flow hedge. More specifically, the request describes a fact pattern in which an entity with a floating rate instrument referenced to an interest rate benchmark, such as LIBOR, enters into an inflation swap (which swaps the variable interest cash flows of the floating rate instrument for variable cash flows based on an inflation index). The request asked whether the entity can designate the swap in a cash flow hedging relationship to hedge changes in the variable interest payments for changes in the real interest rate.

Hedge accounting requirements in IFRS 9

Paragraph 6.1.1 of IFRS 9 states that the objective of hedge accounting is to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss (or other comprehensive income). Paragraph 6.4.1 of IFRS 9 sets out the qualifying criteria for hedge accounting.

One type of hedging relationship described in paragraph 6.5.2 of IFRS 9 is a cash flow hedge in which an entity hedges the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability and could affect profit or loss.

Paragraph 6.3.7 of IFRS 9 specifies that an entity may designate an item in its entirety, or a component of an item, as a hedged item. A risk component may be designated as the hedged item if, based on an assessment within the context of the particular market structure, the risk component is separately identifiable and reliably measurable.

With respect to inflation risk, paragraph B6.3.13 of IFRS 9 states 'there is a rebuttable presumption that unless inflation risk is contractually specified, it is not separately identifiable and reliably measurable and hence cannot be designated as a risk component of a financial instrument'.

Paragraph B6.3.14 of IFRS 9 states that an entity cannot simply impute the terms and conditions of an inflation hedging instrument by projecting its term and conditions onto a nominal interest rate debt instrument. This is because, when developing IFRS 9, the Board specifically considered inflation risk and put in place restrictions to address its concern that entities might impute the terms and conditions of a hedging instrument onto the hedged item 'without proper application of the criteria for designating risk components' as a hedged item (paragraph BC6.193 of IFRS 9). To appropriately account for hedge (in)effectiveness, paragraph B6.5.5 of IFRS 9 requires an entity to measure the (present) value of the hedged item independently of the measurement of the value of the hedging instrument.

Given that the request asked whether the real interest rate component could be designated as a risk component in a cash flow hedge, the Committee's analysis focused on whether a non-contractually specified real interest rate risk component is separately identifiable and reliably measurable in the context of the proposed cash flow hedging relationship described in the request.

Can a non-contractually specified real interest rate risk component be designated as the hedged item in the proposed cash flow hedging relationship?

When considering the qualifying criteria in paragraph 6.4.1 of IFRS 9, the Committee observed that for cash flow hedge accounting to be applied in the fact pattern described in the request, it would be necessary to determine:

- whether that risk component is separately identifiable and reliably measurable as required by paragraph 6.3.7 of IFRS 9; and
- as a result, that the entity has exposure to variability in cash flows that is attributable to the real interest rate risk component of the floating rate instrument as required by paragraph 6.5.2(b) of IFRS 9.

The Committee noted that, to designate a risk component in a hedging relationship, the risk component must be separately identifiable and reliably measurable within the context of each individual hedging relationship. The Committee also noted that it is the market structure—in which a floating rate instrument is issued and in which hedging activity will take place—that needs to support the eligibility of a real interest rate risk component as a non-contractually specified risk component as required by paragraph 6.3.7 of IFRS 9. For the market structure to support the eligibility of that risk component in the proposed cash flow hedging relationship, the real interest rate must represent an identifiable pricing element in setting the floating benchmark interest rate, thereby creating separately identifiable and reliably measurable cash flow variability in the floating rate instrument.

Although the rebuttable presumption in paragraph B6.3.13 of IFRS 9 applies to both fair value hedges and cash flow hedges, the example in paragraph B6.3.14 of IFRS 9 illustrates a rebuttal of the presumption in a fair value hedge. The Committee therefore concluded that, because nominal rates generally do not change as a direct result of changes in real interest rates, the existence in the relevant debt market of a term structure of zero-coupon real interest rates does not, in itself, overcome the rebuttable presumption in paragraph B6.3.13 of IFRS 9 in the proposed cash flow hedging relationship.

The Committee noted that cash flows as defined by paragraph 6 of IAS 7 *Statement of Cash Flows* are, by nature, denominated in nominal terms. The Committee also noted that the interest rate for floating rate financial instruments is defined in nominal terms for a given currency. Therefore, to meet the requirements in IFRS 9 for a cash flow hedge designation, the variability in the cash flows of the floating rate instrument attributable to the designated risk component needs to be assessed in nominal terms. A nominal interest rate (such as LIBOR) may be influenced by expected inflation and the real interest rate in the long term. However, nominal interest rates do not change as a direct result of changes in inflation or the real interest rate (that is, they are not identifiable pricing elements in setting nominal rates).

The Committee therefore concluded that there is no exposure to variability in cash flows that is attributable to changes in the real interest rate in the proposed cash flow hedging relationship and, thus, the requirements in paragraph 6.3.7 and paragraph 6.5.2(b) of IFRS 9 are not met.

Consequently, the real interest rate risk component in the proposed cash flow hedging relationship does not meet the requirements in IFRS 9 to be designated as an eligible hedged item as required by paragraph 6.4.1 of IFRS 9.

The Committee concluded that the requirements in IFRS 9 provide an adequate basis for an entity to determine whether a hedge of the variability in cash flows arising from changes in the real interest rate, rather than the nominal interest rate, could be accounted for as a cash flow hedge. Consequently, the Committee decided not to add a standard-setting project to the work plan.