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Content of the EFRAG discussion paper on pension accounting Issues Paper

Objective

- 1 The purpose of this session is to discuss the structure and content of EFRAG's discussion paper on pension accounting.

Structure

- 2 The EFRAG Secretariat envisages that structure of the main part of the discussion paper would be:
 - (a) Description of the pension plans within the scope of the project and the issue with these plans;
 - (b) Illustration of the issue on an illustrative case;
 - (c) Illustrations of three possible solutions and an analysis of the implications of these approaches;
 - (d) A discussion of other possible approaches and their implications;
 - (e) Issues with IAS 19 *Employee Benefits* not covered by the discussion paper.
- 3 The content of these five sections is presented in the following paragraphs.

Description of the pension plans within the scope of the project and the issue with these plans

Pension plans included in the scope

- 4 The discussion paper will deal with pension plans that are classified as defined benefit plans in accordance with IAS 19 for which the promised benefits are linked to the return on assets held by the plan sponsor or pension fund.
- 5 The EFRAG Secretariat has previously suggested the scope of the project to be plans with a return/based promise meeting the following characteristics:
 - (a) Be categorised as defined benefit plans under IAS 19; and
 - (b) Include a promise to provide benefits that depend on the returns of specified investible items.
- 6 However, at the EFRAG Pension Plans Advisory Panel ('EFRAG PAP') it was noted that a specified investible item could be an item promising a fixed return. EFRAG PAP did not consider that the different credit risk (different counterparty risk) related to promising a fixed return and promising the return on an instrument promising a fixed return was sufficient to warrant different accounting treatments. The main issues with defined benefit plans which include a promise of a return that is linked to assets (see paragraph 11 below), seem to arise when assets are held to fund the

pension plan. The risk structure would also be very different in situations where the assets on which the return is determined are held by the entity and where they are not. For this reason and to clearly define the scope, EFRAG PAP suggested to limit the plans in the scope to those which should be (partly) funded (see paragraph 7 below) and for which the return promise was linked to the return on the assets related to the plan (the plan assets). The promise would not need to be 1:1. Plans that would include a promise of a return of 95 percent or 150 percent of the return on the held assets would thus also be included in the scope.

- 7 EFRAG PAP also suggested that it was sufficient that the entity would either be legally, constructively or contractually obliged to provide funded plans. For determining the scope, it would thus not be relevant to consider whether the plans actually would be funded or not.
- 8 The discussion paper will only consider possible changes to the measurement of pension obligations. EFRAG PAP has noted that measurement of plan assets in accordance with the existing requirements seems to be useful and should therefore not be changed.
- 9 The discussion paper will explain that the scope of the discussion paper is limited to the pension plans described above as these plans seem to correspond well with the plans for which the IASB is considering for a limited project (see below). This increases the likelihood that this project may contribute in practical ways to the future standard-setting activities of the IASB, which is the main objective of EFRAG research activities.
- 10 Some have called for a new accounting approach for plans that share characteristics of both defined contribution and defined benefit plans (see discussion on 'hybrids' below). A survey of defined benefit plans in Europe – although not comprehensive – has shown a wide range of terms and conditionality. It may be unfeasible to develop a solution that applies equally well to all of the variety of schemes, or it could require a high level of complexity.

The issue with the pension plans included in the scope

- 11 Concerns have been raised about the application of the accounting requirements for the type of plans included in the scope. The concerns that will be mentioned in the discussion paper are:
 - (a) IAS 19 requires projecting the benefits using the expected rate of return and to discount them back using the rate of high quality corporate bonds. When the benefit is based on the return of specified assets, the use of different rates is perceived to create an accounting mismatch. In other words, when the benefit is linked to the return of the plan assets, many would argue that the measurement of the liability, including the rate of discount, should reflect the economic linkage to the value of the plan assets.
 - (b) When the minimum guarantee returns are below the historical level of returns on the plan assets, IAS 19 requirements may still result in recognising a liability although the likelihood that the entity needs to pay additional contributions for past periods is low or remote. In these circumstances, the requirements are perceived to be too costly and complex to apply.
 - (c) Examples considered by EFRAG TEG and EFRAG PAP have shown that the current requirements in some circumstances may not result in a net pension obligation being recognised even though it is expected that pension assets are insufficient to cover the pension obligation.

The IASB's activities

- 12 The discussion paper will summarise what has the IASB has been doing on the issues. The discussion paper will note that the IASB has been considering the issue

of plans with a return-based promise but has found it difficult to define an appropriate scope that would result in improvements for a sufficiently wide range of plans without creating unintended consequences.

- 13 The IASB current plan of the IASB is to start a feasibility project on whether it would be possible to eliminate inconsistencies in the measurement of pension benefits that depend on asset returns. The possible scope of the IASB work is probably narrower than the scope of the discussion paper. Currently, it seems as if the IASB will only investigate an approach by which the expected return is set to the discount factor (see below).

Illustration of the issue on an illustrative case

- 14 The discussion paper will show the effects of applying the requirements in IAS 19 for defined benefit plans on a case in which the employees are promised the higher of, at the time of retirement, the actual return on plan assets or a fixed return on plan assets. The amount will be paid as a lump-sum at the time of retirement. The example will be simplified in order to clearly illustrate the issues resulting from applying IAS 19 on the example. For example, it is a one-person plan with no changes in biometric risks. As EFRAG TEG has previously explained a preference for graphical presentations (rather than tables with numbers), two graphs will be shown. One graph will show the gross amounts of the pension obligation and the plan assets as they should be calculated in accordance with IAS 19. In addition, the net pension liability as calculated in accordance with IAS 19 will be illustrated. Another graph will show the service cost recognised in comprehensive income, the cash flows and the total effect on profit or loss and comprehensive income.
- 15 For further information about the example, please see agenda paper 10-03.
- 16 The main purpose of the illustration is to show some of the issues with applying the requirements in IAS 19 on the pension plans included in the scope of the discussion paper. This includes showing how the requirements mean that the measurement of the pension obligation is delinked from the measurement of the plan assets although these values economically are interrelated (although not necessarily identical). In addition, the illustration will show how the backload correction reduces the correlation between the service cost recognised in each period and the cash outflows.
- 17 The accompanying text will accordingly firstly explain when the requirements will result in the net pension liability being measured at an amount which would not sufficiently reflect the outflows expected from the pension plan.
- 18 The text will then provide an assessment of the effects of applying the IAS 19 requirements on the following issues:
 - (a) Is the information useful for predicting future cash flows (estimated value and spread)? In addition to the issue explained in paragraph 17 below, the assessment will address the following questions:
 - (i) Does the information reflect how the pension liability will be settled? The measurement of the pension liability should reflect the value of the liability as of the balance sheet date. To be most useful for predicting future cash outflows, the measurement should reflect the way the entity settles such liabilities.
 - (ii) Is the information relevant for predicting the volatility in future cash flows? In a case where the pension promise would be the return on the plan assets, the only cash outflows occur when the employer is making its contribution. However, if the plan assets and the pension obligation were measured differently, a gain or a loss would be reported from the pension plan in each financial year (in some years it would be a gain in

other years it would be a loss). To assess whether the information is relevant for predicting the volatility in future cash flows, it will therefore be assessed whether economic covariances that impact future cash flows are reflected in the measurement. In this case, whether the portion of the pension obligation directly linked to the value of plan assets and the plan assets are measured similarly.

- (iii) Does the accumulated amount recognised in comprehensive income equal the accumulated amount of net cash flows? It could also be argued that if comprehensive income (or profit or loss) should be used to predict future cash flows, there should ultimately be a link between comprehensive income (or profit or loss) and outflows of resources. The link would generally exist when preparing financial statements in accordance with IFRS. However, IFRS 2 Share-based Payment does not reflect the relationship.
- (b) Is the information relevant for assessing stewardship? In this case, information is assessed to be relevant for assessing stewardship if it provides information about:
 - (i) The additional salary, the entity should have paid to the employee, if the entity had not offered the pension scheme to the employee.
 - (ii) How the risk related to the pension is being managed. That is, financial statements should reflect to what extent the asset allocation covers the pension obligation. The statement of financial position is assessed to provide relevant information for this assessment when the pension obligation is measured similarly to plan assets.
- (c) Is the information useful for assessing solvency? If the measurement of a pension obligation when it is due does not reflect the amount needed to settle the liability, the measurement may not be useful for assessing solvency. Similarly, if a pension asset is used to settle a pension obligation, the net amount should reflect any additional amount that would have to be transferred to settle the liability or any amount that would be left when the liability has been settled.
- (d) Does the approach result in a faithful representation?
 - (i) Is the information presented complete? To be complete, elements that meet the definition of a liability (and the supporting guidance) and the recognition criteria should be included in the statement of financial position. The revised Conceptual Framework will (likely) define a liability as a present obligation of the entity to transfer an economic resource as a result of past events. 'As a result of past events' means that the entity has performed an activity or received the benefits that will or may oblige it to transfer an economic resource that it would not otherwise have had to transfer. An entity has a present obligation when the entity has no practical ability to avoid the transfer.
 - (ii) Would it generally be possible to make reliable estimates?
 - (iii) Would economically similar pension plans be accounted for similarly? That is, when applying the approach, would it be possible that two arrangements that are economically similar would be accounted for differently?
- (e) Would the measurement of the assets/liabilities be prudent, in particular, would there be a higher threshold to reduce a liability (or increase an asset) than to increase a liability (or decrease an asset) – an application of 'asymmetric prudence'?

- (f) Will the information be comparable? If a new approach for accounting for types of pension plans is introduced, this may reduce comparability between financial years of an entity (unless restatement of prior financial statements is made). Whether the information will be comparable with past years will therefore partly depend on the transition requirements, but also on whether it would be possible to gather the information necessary to restate previous years in accordance with the new requirements. It should also be possible to compare the financial statements of different entities. In this regard, it should accordingly be assessed whether the new approach provides information that is comparable with the information resulting from applying IAS 19 to pension plans outside the scope of the project. In assessing this, it is considered whether similar elements of pension plans are accounted for similarly under a proposed new approach and IAS 19. For example, if a return-based pension plan included a minimum return guarantee, would the information under the alternative approach and IAS 19 be similar in those circumstances when the guarantee would de facto determine the amount to pay (so that the return-based element is insignificant)?
- (g) Is the information easy to understand? Information is assessed to be easy to understand if it is easy to explain what it means. In addition, it is assessed that information that can be explained by other means than how it is 'computed' is easier to understand than information that can only be explained by the manner it is 'computed'.
- (h) Is the information costly to provide? Information is assessed to be costlier when it needs to be updated in subsequent accounting periods. Also, information is costlier the more judgement is involved in providing it. Finally, it is assessed that when a lot of input is required, the information will be costlier to produce.

Illustrations of three possible solutions and an analysis of the implications of these approaches

- 19 The discussion paper will show the effects of applying three other approach to the example used to illustrate the effects of applying the requirements in IAS 19 (see above). The approaches that will be considered are:
 - (a) An approach under which the expected return on pension assets is set to equal the discount rate;
 - (b) A fulfilment value approach; and
 - (c) A fair value approach.
- 20 The effects of the three approaches will be assessed using the criteria explained in paragraphs 17 - 18 below. The approaches are further described in the subsections below.

An approach under which the expected return on pension assets is set to equal the discount rate

- 21 A reason for the problems described above in paragraph 11 is that benefits are projected using the expected rate of return (or in this example, the higher of the expected and guaranteed return rate) and then discounted using a high quality corporate bonds rate.
- 22 A simple solution would be to use the discount rate to project the benefits. As EFRAG PAP has noted, this method does not reflect any time value of a guaranteed return promise. Accordingly, the information provided by the method will not be as sophisticated as the information resulting from e.g. the fair value method. However, the EFRAG Secretariat considers that the approach should be illustrated in the discussion paper since it is the approach the IASB is currently intending to explore.

An approach under which the pension obligation is measured at a fair value

- 23 An approach under which plan assets and the pension obligation are measured at fair value would also reduce or remove the accounting mismatches mentioned above in paragraph 11.
- 24 There are, however, many ways in which such an approach could be applied. In the discussion paper, an approach with the following characteristics will be considered:
- (a) All the elements of the pension obligation are measured at fair value;
 - (b) Only the liability for the completed service period is considered;
 - (c) Own credit risk and the likelihood of modifications or curtailments are excluded from the fair value;
 - (d) Similar to IAS 19, non-vested benefits are recognised, but the measurement will reflect the likelihood that the benefits do not vest;
 - (e) When illustrating the effects of the fair value approach, the fair value of the obligation will be calculated as the fair value of the assets (on which the return is determined) plus an estimated fair value of the guaranteed return option.

A fulfilment value approach

- 25 There are a number of similarities between the accounting for insurance contracts in IFRS 17 and pension plans in scope of this project including the following:
- (a) Both insurance contracts and the pension plans in the scope of this project may have a coverage period for many years (long-term);
 - (b) Both include actuarial estimations about financial and non-financial risk. There are estimations on cash inflows and outflows over the life of the insurance contract or pension plan which are discounted; and
 - (c) There are insurance contracts whereby in addition to insurance coverage, the policyholder receives a benefit based on the returns from assets. Therefore, there is a link between the promise and the expected returns on the assets. This is the case for the pension plans in scope of this project.
- 26 Accordingly, an alternative approach to measure pension obligations could be based on fulfilment cash flows, similar to IFRS 17 *Insurance Contracts* ('IFRS 17').
- 27 In IFRS 17, the fulfilment cash flows are defined as an unbiased and probability-weighted estimate (i.e. expected value) of the present value of future cash outflows minus the present value of future cash inflows that will arise as the entity fulfils the insurance contract. It includes a risk adjustment for non-financial risk. In calculating the liability, the entity would estimate all cash inflows and outflows that may arise from the coverage period of the contract. The risk adjustment represents the uncertainty about the amount and timing of the cash flows as the entity fulfils the contract.
- 28 At inception, the residual amount from calculating the fulfilment cash flows, provided that it is above zero, is the contractual service margin ('CSM') and this is the unearned profit that the entity will recognise in the profit or loss statement as it provides services under the insurance contract.
- 29 The CSM, under IFRS 17, is recognised in profit or loss to reflect the services provided over the contract period. Under pension accounting, there would not be a CSM but rather a 'net cost', at inception, which represents the present value of services to be provided by the employees in the future. The 'net cost' is accordingly not immediately expensed but allocated to the expected periods of service.

- 30 When determining the fulfilment cash flows, current discount rates are used, and the entity needs to look at a full range of possible outcomes. The fulfilment cash flows are updated at each reporting date.
- 31 The current discount rates should reflect the characteristics of the cash flows including liquidity characteristics and should be consistent with observable current market prices (if any) for financial instruments that have similar characteristics to insurance contracts. For cash flows that vary based on the returns on underlying items, the discount rate should reflect that variability.
- 32 As stated above, the fulfilment cash flows also include a risk adjustment reflecting the uncertainty in the amount and timing of the cash flows. The risk adjustment is measured separately from the cash flows and the entity can choose an estimation technique to measure it.
- 33 The fulfilment cash flows are reported as a liability. Under pension accounting, on subsequent measurement, any changes to the cash flows and risk adjustment that relate to future periods adjust comprehensive income since there is no CSM as per IFRS 17.
- 34 In computing the insurance liability, IFRS 17 requires an entity to estimate all cash inflows and outflows that may arise from the coverage period of the contract.
- 35 The EFRAG Secretariat and EFRAG PAP have considered three cases when determining what the cash inflows should be included when computing the fulfilment liability:
- (a) Case 1 – Including only the employee contributions in the cash inflows;
 - (b) Case 2 - Including both the employee and employer contributions as cash inflows; and
 - (c) Case 3 - Including both the employee and employer contributions as cash inflows, and also considering the value of the guaranteed return and the risk adjustment to be part of the cash inflows resulting in zero net cost at inception.
- 36 Including the employer's contributions in the inflows may be debatable, because in substance the entity would treat its own payments as a reduction in the liability. In other words, the measurement of the liability would not be affected by how the contributions are split between the parties – it would not matter if the employee pays 0% or 100% of the contributions. On the other side, the employee is required to provide future services so that the benefits can vest. The employer contributions could therefore represent future employee service. The employer's future contributions could be used to measure the value of the future services that cannot be directly measured. The EFRAG Secretariat notes that a similar approach is used in IFRS 2 *Share-based payments* where the value of the instruments granted by the entity is used to measure the services received over the vesting period.
- 37 When the employer's contributions are excluded, the liability increases significantly as can be seen in Paper 10-03.
- 38 In Case 1 and Case 2, there would be a net cost at inception (Case 1 having a larger net cost than Case 2) while for Case 3, at inception, there would be a zero net cost.

A discussion of other possible approaches and their implications

- 39 In addition to presenting the three possible solutions mentioned in the previous section, the discussion paper will shortly describe and explain the consequences of the following approaches:
- (a) The draft IFRIC Interpretation D9 *Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions*.

- (b) An approach under which the expected return is capped to the discount rate. This approach will be quite similar to the approach under which the expected return is set to the discount rate. However, it could be argued that the capped approach is more prudent, as it would not use the discount rate as the expected return if the expected return is lower than the discount rate. This could, for example, happen if the plan assets consist of government bonds.
- (c) An approach under which the various risks included in a pension plan are dissected and accounted for according to the relevant IFRS Standards. In the example used to illustrate the three possible solutions in the previous section, most of the risks are financial risks and should accordingly be accounted for in accordance with IFRS 9 *Financial Instruments*.

Issues with IAS 19 *Employee Benefits* not covered by the discussion paper

40 When discussing issues related to the pension plans included in the scope of the discussion paper, EFRAG PAP members have assessed that some of the general requirements included in IAS 19 contribute to the problems. As the purpose of the discussion paper is not to suggest a complete revision of IAS 19, changes to IAS 19 that would affect how other pension plans are accounted for, have been considered to be outside the scope of the discussion paper. However, many constituents are likely to also mention these other problems with IAS 19 in their responses to the discussion paper. In order to acknowledge these other concerns, the discussion paper will mention these. The issues that will be covered are:

- (a) The binary nature of IAS 19.
- (b) The requirements included in IAS 19 do not reflect the pension plans offered today by many entities which include risk-sharing features.
- (c) It is unclear when to apply the backload correction and the correction:
 - (i) Makes the calculations significantly more complex; and
 - (ii) Makes it more difficult to understand the relationship between the cash outflows for the pension and the recognised cost.

Questions for EFRAG TEG

- 41 Does EFRAG TEG have any comments to the suggested structure of the discussion paper?
- 42 To limit the number of cases illustrated, which of the fulfilment value approaches mentioned in paragraph 35 would EFRAG TEG present in the discussion paper? The two remaining alternatives would not be illustrated, but the discussion paper would explain these alternatives.