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EFRAG Proactive project on Pensions
Cover Note

Objective of the session

1 The objective of this session is to:

(a) Continue the discussion on some of the possible accounting alternatives, with the use of an illustrative example developed by the EFRAG Secretariat;

(b) Provide EFRAG TEG with a summary of the discussion at the initial meeting of the EFRAG Pension Advisory Panel.

Background of the project

Objective of the project

2 The objective of the project is to consider possible amendments to the accounting requirements in IAS 19 *Employee Benefits* in relation to post-employment plans with specific characteristics.

Scope of the project

3 Concerns have been raised about the application of the accounting requirements for defined benefit plans that some refer to as ‘hybrid’, plans that share characteristics of both defined contribution and defined benefit plans. Some of the concerns expressed are:

(a) When the benefits are linked to the return of the plan assets, IAS 19 requires projecting the benefits using the expected rate of return and discounting them back using the rate of high quality corporate bonds. This is perceived to create an accounting mismatch;

(b) In some cases, entities provide minimum guarantee returns that are below the historical level of returns on the plan assets. IAS 19 requirements may result in recognising a defined benefit obligation even in those cases when an outflow of resources has a low probability. Also, the requirements are perceived to be too costly and complex to apply.

4 The EFRAG Secretariat notes that there is no commonly agreed definition of ‘hybrid plans’. Some refer to DC plans with a minimum guaranteed return as hybrids; in other cases, hybrids are considered those plans where the benefits are partially contingent on the plan return, while ‘pure DB plans’ are considered those where the benefits only depend on final-year (or career-average) salary and length of service.

5 The IASB has been considering the issue, but has found difficult to define an appropriate scope that would result in improvements for a sufficiently wide range of plans without creating unintended consequences. Following the completion of the 2015 Agenda consultation, the IASB has a current feasibility project with the objective to consider whether there is a viable solution for plans with a return-based promise.

6 At this stage of the EFRAG project, the EFRAG Secretariat also intends to focus on plans where the promised benefit is linked to the return on specified assets. These plans may include a minimum guarantee return or not, and the benefit may be linked to the return of the plan assets or some other specified assets.

7 The first phase of the project will focus on the measurement requirements for plan assets and pension obligation. At a later stage, we will discuss recognition in P&L and presentation requirements.

Past history

Past discussions with EFRAG TEG

8 In October 2016, the EFRAG Secretariat presented quantitative data on the evolution of pension plans in Europe and a summary of the past IASB activities on the topic.

9 In December 2016, the EFRAG Secretariat presented an initial paper to discuss what elements should be considered in looking for a solution. EFRAG TEG discussed the following elements:

(a) How to select the unit of account;

(b) How to measure pension obligations;

(c) How to measure pension assets;

(d) What discount rate to select when measuring the pension obligation;

(e) The scope of a solution; and

(f) Complexity.

10 EFRAG TEG generally supported to focus on plans with the characteristics described in paragraph 6 above. The possible solutions that would be considered should address the issue identified in paragraph 3(a) above for many different types of the pension plans within the scope of the project. The complexity of the various solutions should be considered, however, only at a later stage of the project.

11 In February, EFRAG TEG discussed an initial draft of the illustrative example with the following alternatives:

(a) A model where the measurement of the pension obligations reflects the measurement of the plan assets;

(b) A model where the measurement of the plan assets is linked to the measurement of the pension obligation;

(c) A model where with an expected asset return capped to the high quality corporate bond rate (‘HQCB rate’);

(d) A fair value model. It was noted that a full fair value model would not reflect the fact that these obligations are rarely transferred;

(e) A fulfilment value model based on IFRS 17 *Insurance Contracts.* It was noted that one of the issues would be the treatment of the employer’s contributions (or the loss initially calculated, if these contributions are excluded);

(f) A defined contribution approach where the expense of the period would be the entity's contribution and the change in the value of a guarantee component.

12 EFRAG TEG was not asked to take any decision. It was agreed that the illustrative example should be amended to reflect an assumption that the beneficiary would stay in service until retirement.

Past discussion with EFRAG User Panel

13 In May 2017, the EFRAG User Panel discussed usefulness and relevance of pensions disclosure under IAS 19 and in particular whether plan assets and pension liabilities should be presented on a gross or net basis.

14 Some User Panel members preferred a gross presentation because the two balances are sensitive factors.

15 The User Panel confirmed that it is useful to have information on expected disbursement over the next years.

16 The User Panel discussed the difference in measurement between IAS 19 and IFRS 17. The members thought that an insurance accounting approach should be considered where hybrid pension plan structures create guarantees as these plans are not well captured by the existing pension standard. In addition, they agreed that, if the IFRS 17 model was applied to pension obligations, it should not result in the recognition of a Day-1 gain.

17 User Panel members also noted that when the pension would depend on the return of specified assets and these would be held by a pension fund separate from the entity, the entity should not reflect the pension assets in its financial statements, as it would not control these. Accordingly, the pension obligation should also not be recognised. The pension scheme should accordingly be accounted for as a defined contribution scheme. An obligation to provide a minimum return should be recognised separately. EFRAG User Panel members did not indicate how the return guarantee should be measured.

Discussion with EFRAG Pension Advisory Panel

18 The EFRAG Pension Advisory Panel chaired by Nicklas Grip had its initial meeting in April 2017. The EFRAG Secretariat illustrated the scope of the project and a revised example. The main points arising from the discussion were:

(a) Some Panel members questioned the scope of the research project and suggested that all plans with a minimum return guarantee should be addressed (regardless of whether there is a return-linked promise). Particularly, some members thought that issues related to the Dutch pension plans should be considered[1];

(b) There was consensus that at least some of the alternatives would result in accounting outcomes that depict better the economics of the plan. It was noted that in some countries the approach under D9 is generally accepted;

[1] Some Dutch schemes work similarly to defined contribution schemes for the employer. However, the pension fund may have a right – within certain limits – to require the entity to make higher contributions in the future to fund a plan deficit. The plan is therefore accounted for as a defined benefit plan by the entities. The EFRAG Secretariat is currently considering whether these types of plans can be considered within the scope of the project.

(c) There was some discussion on the application of the projected unit credit method and under what circumstances the total benefits should be allocated on a straight-line basis;

(d) Panel members were not asked to rank the alternatives. However, there was little support for the model where plan assets are measured with reference to the measurement of the pension obligation. Panel members disagreed that the IFRS 17 model could result in the recognition of a Day-1 loss - the approach should attribute the cost over the expected period of service;

(e) Some Panel members argued that defined contribution accounting should be allowed for these plans. Conceptually the sponsor is only exposed if the expected return falls below the guaranteed return – if this was stripped out, the plan would be a DC plan. In relation to the guarantee, Panel members agreed that fair value measurement could be appropriate but it would likely require the use of complex Monte Carlo simulations and be costly. Some suggested to avoid recognition and provide disclosures of the risk exposure;

(f) Some Panel members were concerned about the potential understatement of the pension service cost under some of the approaches;

(g) Panel members with a user background noted that there should be more linkage or at least a reconciliation between cash flows and amounts recognised as cost for the year. Information on future disbursements would also be helpful;

(h) Panel members asked to amend the illustrative example to illustrate how the different alternatives would work when the expected return shifts from above to below the minimum guarantee (or the other way around).

19 The next Advisory Panel meeting will occur in July. The EFRAG Secretariat plans to present some quantitative data on pension asset allocation and descriptive data on occupational plans in European countries. The discussion on the different approaches will continue with revised illustrative examples. Finally, Panel members will be asked for their views on the practical difficulties to assess the measurement input required under IAS 19.

Planned future outcome

20 The planned outcome is a discussion paper that would discuss possible alternatives to improve the accounting of these plans, with a view to provide input into the IASB's project.

Agenda papers

21 In addition to this cover note, the agenda paper for this session is Paper 04-02 – Approaches for Accounting for Return-Based Pension Plans.