EFRAG Research activities

Update on Pension plans project

Objective

1 The objective of this session is to provide a short update on status of the EFRAG research project on Pension plans

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 defined benefit plans *with a return-based promise*.

3 Originally, the scope of the project covered plans with a return-based promise that met the following characteristics:

(a) They qualify as defined benefit plans under IAS 19; and

(b) The benefits depend on the returns of specified investible items (usually financial instruments, but could also include non-financial assets such as real estate).

4 The EFRAG Pension Plans Advisory Panel suggested to limit the scope to plans where the benefits would depend on the returns of assets held by the entity. The latter criterion is met regardless of whether the pension plan is fully funded and whether the return on the assets and the return passed to the beneficiaries is 1:1.

What are the issues we are looking at?

5 Concerns have been raised about the application of the accounting requirements for this type of plans:

(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;

(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 entity is highly unlikely to pay additional contributions for past periods. In these circumstances, the requirements are perceived to be too costly and complex to apply.

6 When the benefit is linked to the return of the plan assets, it is argued that the measurement of the liability, including the rate of discount, should reflect the economic linkage to the value of the plan assets.

What has the IASB been doing on the issues?

7 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.

8 In 2004, the IFRS Interpretations Committee ('IFRS IC') issued draft Interpretation D9 *Employee Benefits Plans with a Promised Return on Contributions or Nominal Contributions.* The draft Interpretation applied to plans with a promised return on actual or notional contributions. A promised return was defined as either a guaranteed return of a fixed amount (or rate) or a promise of a variable return based on specified assets or indices.

9 IFRS IC then decided to suspend the project because the IASB was considering a revision of IAS 19. However, the revision of IAS 19 – which resulted in the elimination of the corridor approach – did not address in full the issue of the linkage between the benefit and the return of specified assets.

10 Based on the feedback received on its 2015 Agenda consultation, the IASB decided that there was no evidence of problems that were sufficiently widespread and significant to require a comprehensive review of the IAS 19. The IASB concluded that it would start a feasibility project on the measurement of pension benefits that depend on asset returns.

11 At this stage, the IASB will investigate only whether entities should cap the projection of the plan benefits at the rate used to discount the pension liability. The scope of the IASB feasibility study is substantially aligned to the EFRAG research project, although the range of solutions EFRAG is considering is broader.

Status of the EFRAG project

12 The EFRAG Pension Plans Advisory Panel has had a number of meetings from June 2017 to March 2018. Discussions have mostly focused on alternative ways to measure the defined benefit liability (asset). The Panel has considered the following alternatives based on illustrative examples:

(a) A model under which the expected returns on the plan assets are capped (or set) at the rate used to discount the pension liability;

(b) A model under which the pension obligation reflects the measurement of the plan assets;

(c) A fulfilment model that builds on some of the principles in IFRS 17 *Insurance Contracts*;

(d) A model under which the pension obligation is measured at fair value.

13 The first two models are close to the existing requirements in IAS 19. The last two models are more different and there are a number of aspects that were debated at length.

14 In relation to the fulfilment model, questions were raised in relation to:

(a) Whether the plan inflows should also include the employer's contributions;

(b) How to allocate an initial 'deficit' over the projected service period;

(c) If and how the discount rate should incorporate a risk margin; and

(d) How to account for the minimum return guarantee if, at inception, the expected returns are deemed to exceed it.

15 In relation to the fair value model, aspects such as what characteristics of the plan should be reflected in the measurement and how difficult would be to estimate the fair value have been discussed.

16 At the last meeting, the Panel started discussions around the allocation of the change in defined benefit liability (asset) between profit or loss and other comprehensive income, as well as disclosure objectives.

Other aspects

17 Panel members raised other concerns in relation to some of the requirements in IAS 19, that go beyond the scope selected for the research project. For completeness and clarity, it is appropriate to illustrate these concerns.

The binary nature of IAS 19

18 IAS 19 classifies all defined benefit using a binary distinction – defined contribution (‘DC plans’) and defined benefit plans (‘DB plans’). For each plan, the sponsoring entity needs to assess if the criteria to be classified as a DC plan are met; any plan that does not meet the criteria falls into the residual category of DB plans.

19 The definition in IAS 19 does not require to consider whether the sponsoring entity's risks are substantial, although the general materiality requirements apply. When the risk is insignificant, some would argue that these plans are economically similar to plans where the entity's obligation is limited to the contributions. Also, the definition does not further elaborate on the nature of the risk exposure.

Risk-sharing features

20 In the last decades traditional DB plans have come under pressure due to a combination of increased longevity of plan participants, reduction in active workforce and decreasing or even negative investment yields.

21 As a result, entities have moved away from traditional plans and have tried to introduce risk-sharing features. Plans with these characteristics - that can encompass a range of different alternatives - are often referred to as 'hybrid plans', which is not a term defined in the Standard.

22 One example of the perceived intermediate category is so-called 'defined ambition' (or 'target-benefit') plans, that have been introduced in Canada and the Netherlands. These plans share the funding risk across the participants due to following mechanisms:

(a) The contributions are fixed or may vary in a narrow range only;

(b) Plan members are offered a target benefit at retirement, however, the benefits may be adjusted up or down to balance the plan's funding.

23 Another example is cash balance plans. In a cash balance plan, the sponsoring entity is exposed to the investment risk rather than the plan participants. However, they define the benefit as a stated individual account balance made up by contributions and interest credit, which may be fixed or variable. These are often referred to as "hypothetical accounts" because they do not reflect actual contributions to an account or actual gains and losses allocable to the account.

24 The IAS 19 revision in 2011 addressed some risk-sharing features, but did not change the requirement to account for these plans as defined benefit plans.

The projected unit credit method and its scope of application

25 For DB plans, IAS 19 requires the application of the projected unit credit method. If the employer's service in later years lead to material increases in the benefits, the entity is required to allocate the benefit in a straight-line basis over the projected service period. This is regardless of whether the benefits are vested or not at the reporting date (in other words, whether the employee would be entitled to the benefits if employment terminated at the reporting date). The method reflects the view that a post-retirement benefit is a stipulation that covers the full period of service.

26 Regardless of whether there is consensus about this view, there are concerns on the lack of clarity on when the benefits should be allocated on a straight-line basis. There are different formulas under which a salary increase results in an increase of the benefit for later years of service, but IAS 19 is not clear on whether every such formula requires applying the method.

27 One additional concern is that allocating the benefits on a straight-line basis results in a pattern of service costs that is quite different from that of contributions paid. If investors are using the service cost as a proxy to project future pension cash outflows, then it may be argued that recognising the cost in a similar pattern as the cash flows could improve the relevance of the information. On the other side, explaining the nature of the difference between the two in the notes could also provide adequate information.

International perspective

28 The staff of the Canadian Standard Setter presented a paper on pensions on behalf of the Pensions Working Group (PWG) at the September 2017 IFASS meeting. The PWG comprises of the technical staff from AcSB (Canada), DRSC (Germany), ASBJ (Japan), UK FRC, and FASB.

29 The paper provided an analysis of the information collected in 2016 by almost 25 audit and benefit consulting firms. The paper did not provide a formal definition of hybrid plans, however, that term was used to refer to *pension plans that were neither traditional DC plans nor traditional DB plans but rather somewhere in between.* This results in the inclusion of a range of plans with fairly different terms.

30 The conclusion of the PWG outreach was that classification and measurement requirements create accounting challenges in respect to these hybrid plans. The PWG tentatively identified a number of ways forward:

(a) Unbundling guarantees/risk elements from contribution-based promises;

(b) Considering likelihood (probability) of applying the guarantee when classifying a plan into a DC or DB model;

(c) Developing separate measurement methodologies for plans with benefits linked to returns;

(d) Defining and measuring the guarantee;

(e) Introducing flexibility in applying, or providing an alternative to, the projected unit credit method;

(f) Applying a fulfilment value model to pension obligations similar to IFRS 17; and

(g) Measuring the effect of risk-bearing arrangements that represent purely financial risks on a net rather than a gross basis.

31 The PWG noted that each alternative may address some, but not necessarily all the issues identified.

32 The EFRAG Secretariat has established an informal exchange of views with the staff of the Canadian Standard Setter leading the project.

Question to EFRAG Board

33 Do you have any comments or questions on the status of the project?