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DISCUSSION PAPER

ACCOUNTING FOR PLANS WITH ASSET-RETURN PROMISE

[MONTH] 2019



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DISCLAIMER

EFRAG, while encouraging debate on the issues presented in the paper, does not express any opinion on those matters at this stage.

Copies of the Discussion Paper are available from EFRAG's websites. A limited number of copies of the Discussion Paper will also be made available in printed form, and can be obtained from EFRAG.

EFRAG welcomes comments on its proposals via the 'Questions to Constituents' at the end of each section. Such comments should be submitted through the EFRAG website by clicking or should be sent by post to:

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Comments should arrive no later than [Comment Deadline Date]. EFRAG will place all comments received on the public record unless confidentiality is requested.

EFRAG RESEARCH ACTIVITIES IN EUROPE

This paper is part of EFRAG's research work. EFRAG aims to influence future standard-setting developments by engaging with European constituents and providing timely and effective input to early phases of the IASB's work. Four strategic aims underpin proactive work:

- engaging with European constituents to understand their issues and how financial reporting affects them;
- influencing the development of International Financial Reporting Standards ('IFRS Standards');
- providing thought leadership in developing the principles and practices that underpin financial reporting; and
- promoting solutions that improve the quality of information, are practical, and enhance transparency and accountability.

More detailed information about our research work and current projects is available on the EFRAG website.

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EXECUTIVE SUMMARY

- ES1 The objective of this Discussion Paper is to explore alternative accounting treatments for post-retirement employee benefits, also referred to as pensions plans, with an asset-return promise. For the purpose of the Discussion Paper, a pension plan includes an asset-return promise when the benefit amounts to the higher of the return on an identified item or group of items – for example, a portfolio of equities; and a minimum guaranteed return.
- ES2 Plans with a promise of variable returns based on a specified asset were the object of previous work by the IFRS Interpretations Committee. The main perceived issue with these plans is that the discount rate prescribed by IAS 19 *Employee Benefits*, a high quality corporate bond rate, may not be appropriate for the benefits that depend on future returns on assets.
- ES3 The Introduction provides some background to the discussion and a brief description of how pension accounting has evolved and the current developments of occupational pension plans in Europe.
- ES4 Chapter 2 introduces the proposed scope and explains why it has been selected. The proposed scope of the Discussion Paper is pension plans with an asset-return promise where the plan holds the assets upon which the benefits are dependent. EFRAG understands that plans with asset-return promises are common in some European countries, and infrequent in others. Constituents are invited to provide their views on the proposed scope.
- ES5 Chapter 3 describes the current requirements for defined benefit plans under IAS 19. The chapter uses a simplified case to illustrate the accounting outcome under the existing requirements. In particular, the simplified example considers changes in the financial assumptions (e.g. expected returns on plan assets and discount rates) but not in other actuarial assumptions (e.g. period of service and salary increases). The chapter also describes the assumptions of the simplified example.
- ES6 Chapter 4 illustrates three accounting treatments that are alternative to the existing requirements in IAS 19:
- a) A *Capped Return Asset* approach, under which the rates used to project the final benefit entitlement are capped to the discount rate;
 - b) A *Fair Value Based* approach, under which the measurement of the pension obligation is based on fair value; and
 - c) A *Fulfilment Value* approach, under which the measurement of the pension obligation is based on the present value of the fulfilment cash flows and the value of the minimum return guarantee. The measurement of the fulfilment cash flows draws from elements of the measurement model in IFRS 17 *Insurance Contracts*.
- ES7 The Discussion Paper uses the same simplified case to compare the outcome of the three approaches to the outcome of the existing requirements, and provides an explanation for some of the different outcomes. In order not to make the Discussion Paper lengthy and less readable, the detailed calculations for each approach are not included in this Discussion

Paper. The details are, however, included in a separate EFRAG Secretariat background paper which is available on EFRAG website.

- ES8 Each of the alternative accounting treatments has advantages and disadvantages. Chapter 5 of the Discussion Paper provides an initial assessment of the alternative accounting treatments. For the assessment, reference is made to the qualitative characteristics in the *Conceptual Framework for Financial Reporting*.
- ES9 Chapter 7 briefly describes other alternative approaches that were discussed during the development of the Discussion Paper. The Discussion Paper does not apply the illustrative example and qualitative assessment to the approaches described in Chapter 7.
- ES10 The Discussion Paper acknowledges that other concerns have been raised in relation to the accounting for post-retirement employee benefits. Chapter 8 provides a short discussion of these other concerns.



QUESTIONS TO CONSTITUENTS

EFRAG invites comments on all matters in this Discussion Paper, particularly in relation to the questions set out below. Comments are more helpful if they:

address the question as stated;

indicate the specific paragraph reference to which the comments relate; and/or

describe any alternative approaches that should be considered.

All comments should be received by [Submission date].

Question 1 - Scope

Q1.1 Do you consider that the scope of pension plans with asset-return promise should be limited to pension plans where the entity holds the plan assets? Please explain.

Question 2 - Presentation of remeasurements under the Fair Value Based approach and the Fulfilment Value approach

Q2.1 In this Discussion Paper it is assumed that remeasurements under the Fair Value Based approach and the Fulfilment Value approach are presented in profit or loss. Do you agree with this approach. If not, how would you present components of defined benefit costs other than service costs?

Question 3 - Risk adjustment for Fulfilment Value approach

Q3.1 As stated in paragraphs 4.56 to 4.57, we consider that a risk adjustment is needed. Do you agree? What do you consider that it will cover?

Question 4 – Alternative approaches

Q4.1 Do you think there are other approaches to account for the pension plans within the scope of this Discussion Paper that should have been considered? If so, which approaches?

Question 5 - Assessment of approaches – Assessment of complexity

Q5.1 The assessment in Chapter 5 of the costs related to the various approaches presented in this Discussion Paper, only considers implementation costs. Do you think that the complexity related to preparing financial information in accordance with the approaches would differ significantly? If, so which approaches would be the most complex and least complex to apply?

Question 6 – Assessment of approaches – Aspects to consider

Q6.1 Do you agree with the aspects of qualitative characteristic considered in the assessment of the various approaches in Chapter 5? If not, which aspects do you think should/should not have been considered?

Question 7 – Assessment of approaches

Q7.1 Do you agree with the assessment of the various approaches made in Chapter 5? If not, how would you assess the approaches?

Question 8 – Disclosure

Q8.1 Do you think that additional disclosure requirement about pension plans included in scope of this Discussion Paper should be added to the requirements already included in IAS 19?

Question 9 – Choice of approach

Q9.1 How do you think pension plans covered in the scope of this Discussion Paper should be accounted for?

CHAPTER 1: INTRODUCTION

- 1.1 When IAS 19 *Accounting for Retirement Benefits* was originally developed, it was mainly designed to cover traditional defined benefit plans, under which amounts to be paid at retirement were determinable, and defined contribution plans under which amounts to be paid at retirement benefits were determined by contributions to a fund together with investment earnings thereon.
- 1.2 Now, however, a growing range of plans - often referred to as 'hybrid' plans - are designed to incorporate features that were not envisaged when IAS 19 was developed. Among others, such plans are introduced by entities to reduce their exposure to pension risks. Although 'hybrid' plans differ from traditional typical defined benefit plans, they still satisfy the defined benefit plan classification criteria provided in IAS 19 *Employee Benefits*. Therefore, IAS 19 defined benefit plan accounting applies to the 'hybrid' plans. 'Hybrid' plans are common in some European jurisdictions e.g. in Germany, Netherlands, Belgium and Switzerland.
- 1.3 This paper addresses possible amendments to the accounting requirements in IAS 19 for one type of 'hybrid' plans. The type of plan considered is a plan under which the final benefit depends on the higher of the return on plan assets and a minimum guaranteed return.
- 1.4 As a short introduction to the topic, a summary of how pension accounting has developed over time and some statistics on pension plans are provided below. A short description of current requirements in IAS 19 and a comparison with US GAAP guidance are provided in Appendix 1.

Evolution of pension accounting¹

- 1.5 Historically, reporting on pensions focused on the pension cost rather than on measuring an entity's rights and obligations under the plan. The pensions were viewed as a gratuity act from the employer for past services. Consequently, the employer was not seen to have a present obligation, and the pension cost was linked to the cash outflows. The pension benefits were paid entirely at the employer's discretion and could be discontinued at any time. The cost was measured either by the pension benefit paid; or by the contribution paid in a funded scheme. The cost could also include the guaranteed return, if the contributions were not segregated to buy securities.
- 1.6 For defined benefit plans, two broad groups of accounting schemes evolved: a *terminal funding method*, where the projected cost of retirement was recognised only at the time an employee retired, and *pay-as-you-go methods*, where the cost of retirement benefits was recognised only at the time that cash payments were made to employees on or after retirement.
- 1.7 Over time, the gratuity theory was challenged by the view that a pension is a 'deferred pay' and that employees accepted lower wages in exchange for future expected income. This led to the conclusion that an entity should account for the cost to provide the future employee benefits. That accounting change was driven by governments granting tax

¹ This section draws from Napier, C. (2008) *The logic of pension accounting*

deduction for pension costs. As a result, the annual cost of the pension provision was measured based on actuarial calculations (when the firm was using internal funding) or through contributions to external funds, also determined based on actuarial calculations. In the last case, the cost would still correspond to the cash outflow of the period.

- 1.8 In the 1970's, the accounting theory further developed by introducing the notion that pension benefits are exchanges for total services provided over the employee's working life with the employer. While the employer's side of the exchange was identifiable – i.e. the promise to pay benefits – the employee's side was less clear. It was suggested that the employee accepted to provide services in exchange of the future pension promise and, since it was not possible to allocate benefits to specific units of service, the objective of accounting should be to spread the value of the benefits to the full period of service. Moreover, stock market declines with abnormally high price inflation led to deficits on actuarial valuations. This initiated further research on pension accounting.
- 1.9 The evolution of the accounting theory, summarised above, led to changes in the accounting and reporting requirements.
- 1.10 The original International Accounting Standard on pensions, IAS 19 *Accounting for Retirement Benefits in the Financial Statements of Enterprises*, issued in January 1983 by the IASC – the predecessor of the IASB - was oriented towards measuring the pension cost in the income statement. The Standard distinguished between accounting and funding objectives and introduced a dual model i.e. it required classifying a retirement benefits plan as either defined contribution or defined benefit. For defined benefit plans, the use of pay-as-you-go and termination funding methods was prohibited and, instead, the Standard required charging the pension costs to income systematically over the expected remaining working lives of the employees. Nevertheless, the Standard remained flexible enough to permit entities choosing the actuarial method to be used to determine the retirement benefit from a wide range of accrued benefit or projected benefit valuation methods and, in particular, to decide whether or not to use salary projections in measuring the pension expense.
- 1.11 The US Accounting Principles Board ('APB') Opinion No.8 *Accounting for the Cost of Pension Plans* was issued in 1966. It also focused on the treatment for the cost attributed to past or prior service and recommended spreading the costs over a period of up to 40 years. The Opinion recommended that the accounting impact of actuarial gains and losses should be accounted for by spreading them over ten to twenty years, or by adjusting the cost by an estimate of the average actuarial gains and losses arising over several years. That treatment was also influenced by tax rules, that limited the deductibility of these components. In 1985, the US SFAS 87 *Employers' Accounting for Pensions* was issued which required the assessment of the projected benefit obligation based on future compensation levels. The projected benefit obligation was determined as the actuarial present value as of a date of all benefits attributed by the pension benefit formula to employee service rendered prior to that date.
- 1.12 IAS 19 *Employee Benefits*, revised in 1998, moved closer to a balance sheet approach. The standard kept the dual model, but prohibited the use of the accrual valuation method. Similarly, the FASB revised SFAS No. 87 in SFAS 158 *Employers' Accounting for Defined Benefits Pensions and Other Postretirement Plans*, published in 2006, which required measurement of the liability by comparing the fair value of the plan assets with the projected benefit obligation rather than the accrued benefit obligation.
- 1.13 Under current IAS 19 guidance, an entity uses an actuarial technique (the projected unit credit method) to estimate the ultimate cost to the entity of the benefits that employees

have earned in return for their service in the current and prior periods and then discounts that benefit in order to determine the present value of the defined benefit obligation.

- 1.14 As presented above, the accounting requirements shifted from just reporting the pension cost and focused on measuring the pension liability. The measurement of the pension liability shifted from a variety of permitted actuarial methods to a single permitted projected unit credit method.
- 1.15 However, recently, the employers have tended to shift from defined benefit to defined contribution schemes² - see also the sub-chapter on statistics below. Statistical analyses indicated that greater costs of administering defined benefit plans relative to defined contribution plans were associated with new adopters favouring defined contribution plans. Furthermore, greater economic instability in industries led new pension plan adopters to be more likely to choose defined contribution plans rather than defined benefit plans, presumably because the former represented less risk for the employer. In addition, higher capital/labour ratios, lower company sizes, and lower proportions of blue-collar workers within an industry favoured adoption of defined contribution plans among new adopters.
- 1.16 Nevertheless, in some cases, entities have not wanted to or have not been able to remove all the risks related to defined benefit plans by replacing defined benefit schemes with defined contribution schemes. As it was noted in an IASB staff paper for the November 2015 IASB meeting³, converting defined benefit plans into pure defined contribution plans could have been difficult for some entities because introducing them may make it more difficult to retain employees or because of pension regulations. An example of the latter is local legislation requirements resulting in some entities having to introduce minimum guaranteed returns to plans that would otherwise be accounted for as defined contribution plans. This results in such pension schemes having to be accounted for as defined benefit plans. The minimum guaranteed returns are typically below the historical level of returns on the plan assets and are often led by local legislation requirements.
- 1.17 Newly introduced pension schemes, which evolved in order to reduce the risks to which employers are exposed under defined benefit plans, are thus seen as having elements of both traditional defined contribution plans and traditional defined benefit plans. Such schemes include shared-risk plans, cash balance plans, security-linked plans, and plans with an asset-return promise. As the plans have elements of both traditional defined contribution plans and traditional defined benefit plans, concerns have been raised about the application of the defined benefit accounting requirements to such plans. For example, IAS 19 requirements may result in recognising a defined benefit obligation even in cases when a further outflow of resources has a remote probability of occurring. Also, the requirements are perceived to be too costly and too complex to apply.

² Douglas L. Kruse, Pension Substitution in the 1980s: Why the Shift toward defined Contribution?

³ Agenda Paper 15A for the November 2015 IASB meeting.

Statistics

- 1.18 As mentioned above, entities are, to some extent, moving away from offering defined benefit pension schemes to offering defined contribution schemes. The table below shows the cost of defined benefit schemes in percentage of the cost to both defined benefit plans and defined contribution plans for listed entities within the EEA countries⁴. The table shows that from 2010 to 2014 there was a relative decline in the cost to defined benefit plans.

	2010	2011	2012	2013	2014
Entities	865	931	969	1 007	1 048
Average	41%	38%	36%	36%	34%
1 st quantile	16%	13%	11%	12%	11%
Median	36%	31%	30%	29%	27%
3 rd quantile	65%	59%	54%	57%	53%
95 th percentile	91%	89%	90%	87%	85%
97.5 th percentile	95%	93%	94%	92%	91%

- 1.19 The following table illustrates the ratio of costs for defined benefit plans to the combined costs for defined contribution plans and defined benefit plans for listed entities in the EEA countries. The table shows the average median over the period. Since the table is based on the country of incorporation of the parent entity, and groups operate in different jurisdictions, the figures may not provide an exact depiction of the situation in each country. Countries where the average number of entities was less than 30 have been marked with an asterisk.

Country	Average median (%)	Country	Average median (%)
Portugal*	77	France	23
Liechtenstein*	74	Sweden	20
Austria	72	Poland*	20
Malta*	57	Hungary*	14
Spain*	55	Greece*	13
Belgium	50	Finland	11
Norway	50	Denmark*	10
Ireland*	47	Slovenia*	9
United Kingdom	42	Latvia*	7
Luxembourg*	41	Lithuania*	6
Netherlands *	34	Slovakia*	6
Cyprus*	30	Romania*	4
Germany	29	Croatia*	3
Iceland*	28	Bulgaria*	2
Italy	27	Estonia*	No data
Czech Republic*	24		

⁴ Only entities for which costs to both plans were higher than zero in the S&P Capital IQ database were chosen for the statistics.

- 1.20 The data in the table indicates that there could be significant differences between entities incorporated in different jurisdictions in relation to the significance of costs related to defined benefit schemes compared with costs related to defined contribution plans.
- 1.21 From the IASB staff paper for the November 2015 IASB meeting, it appears that hybrid plans, of which some may be of the types included within the scope of this Discussion Paper, are as common as traditional defined benefit plans and pure defined contribution plans in the EEA countries⁵.



⁵ The IASB staff paper bases this observation on the fact that in a study performed by using data collected by EIOPA, 55 plans, out of a total of 156 types of occupational plans were classified as traditional defined benefit plans; 51 were classified as pure defined contribution plans with no guarantees; 9 plans were classified as defined benefit plans in which benefits are mostly determined by the contributions paid and the results of their investments, but the employers have the responsibility for the minimum guarantees; 21 were classified as plans operated like defined contribution plans but provided guarantees; 16 plans were classified as plans with both defined benefit components and defined contribution components; and 4 plans were classified as 'Others'. The data on which the IASB staff paper's conclusion is based is derived from information on pension plans and products with a focus on occupational and personal pensions. Such pension plans and products often are not within the remit (or on the balance sheet) of a particular employer. The IASB's study simply count the number of plans – not how many employees are covered by the plans. In addition, the EIOPA data does not distinguish between pension plans offered by employers and pension plans offered directly to employees. It can therefore not be concluded from the data collected by EIOPA that hybrid plans are offered as frequently by entities in the EEA as "normal" defined contributions plans or defined benefit plans.

CHAPTER 2: DESCRIPTION OF THE PLANS WITHIN THE SCOPE

Definition of pension plans included in the scope

- 2.1 This Discussion Paper deals with the reporting of post-retirement pension plans that meet the following characteristics:
- (a) They include an asset-return promise; and
 - (b) The plan holds the plan assets upon which the benefits are dependent.
- 2.2 For the purpose of this Discussion Paper, an asset-return promise is defined as a post-employment benefit which amounts to the higher of the return on an identified item or group of items – for example, a portfolio of equities; and a minimum guaranteed return.
- 2.3 The plan does not need to transfer exactly the returns generated by the plan assets. A plan would not be excluded from the scope because it promises a benefit equal only to a share of the returns.
- 2.4 However, an obligation to include the asset returns in the benefits must have arisen to the entity under the plan. If the entity has discretion in including any portion of the asset returns in the benefits, then a plan would not fall into the scope. An obligation can arise from the law, the terms of the plan or established past practices.
- 2.5 The scope does not include plans with a minimum guaranteed return unless they also include a promise based on the return of plan assets. For example, a plan under which the sponsor pays a fixed contribution and only guarantees a return of 4% p.a. would not be included in the scope of the project.
- 2.6 A plan that includes an asset-return promise is fundamentally different from a plan that promises only a guaranteed return. For one thing, the entity cannot use any excess return to reduce its contributions under the plan.
- 2.7 EFRAG initially considered a scope that would include also plans that specify the pool of items based on which the return would be determined, but where the plan does not hold the items. There is a different risk exposure in the two cases – if the plan holds the items (the assets), the entity is only exposed to the risk that the actual returns do not exceed the minimum guaranteed return. On the other hand, if the plan does not hold the items, the entity is also exposed to the risk that the return earned on any alternative investment is lower than the return on the specified pool of items. In the latter cases, there is also the possibility that the return earned on the alternative investment exceeds the return on the specified items, which would allow the sponsoring entity to pay less contributions.
- 2.8 It is debatable if, from a conceptual perspective, the different exposure to risks (and rewards) should result in a different accounting treatment. Indeed, the scope of this Discussion Paper results in plans under which the entities hold the assets on which the return is determined, and plans for which this is not the case are accounted for differently. EFRAG considers that more work is needed to assess if the approaches explored in this Discussion Paper would also be valid for plans where the plan does not hold the items upon which the benefits are dependent.

- 2.9 As a consequence of the decision reflected in the paragraphs above, the plans within the scope of this Discussion Paper must be funded. In other words, it is necessary that the entity settles regularly the contributions specified in the terms of the plan. However, it is not necessary that the entity immediately funds any projected shortfall due to expectation about the guarantee becoming effective.
- 2.10 The Discussion Paper addresses the measurement of the pension obligations for the plans within the scope. EFRAG has concluded that the measurement of plan assets at fair value in the statement of financial position is useful and provides relevant information. Accordingly, the Discussion Paper does not further discuss the measurement of plan assets.
- 2.11 EFRAG has chosen the scope of this Discussion Paper as the IASB is currently considering possible amendments to IAS 19 for pension benefits that depend on asset returns. Thus, 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.
- 2.12 EFRAG acknowledges that there are reservations about other aspects of pension accounting, than the issues that are subject to special attention in this Discussion Paper. One of these issues is described in Chapter 8. EFRAG has not further addressed those other issues, as it considered that the issues around the plans with an asset-return promise can be addressed without a fundamental rethinking of IAS 19. The IASB Agenda consultation did not show constituents' support to fundamentally review the Standard, which was significantly amended in 2011.
- 2.13 EFRAG also acknowledges existence of other types of plans, referred to as hybrid plans, which will not be covered by the scope of this Discussion Paper. Some have called for a new accounting approach for plans that share characteristics of both defined contribution and defined benefit plans – often referred to 'hybrid' plans. A survey of defined benefit plans in Europe - although not comprehensive - has shown a wide range of terms and conditionalities. 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

- 2.14 Concerns have been raised about the application of the accounting requirements for the type of plans included in the scope of this Discussion Paper. The main concern derives from the requirements to project the benefits using the expected return rate and to discount them back using market yields on 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.
- 2.15 In other words, when the benefit is linked to the return of the plan assets, many would argue that the measurement of the obligation, including the rate of discount, should reflect the economic linkage to the value of the plan assets. This perceived misalignment is also due to the fact that the plan assets are carried at fair value, which means that their accounting reflects the actual returns and not the projected returns.
- 2.16 Another concern is that the existing IAS 19 requirements may still result in recognising a net pension liability when the likelihood that the entity needs to pay additional contributions for past periods is low or remote. This occurs when the guarantee is set at a level which is significantly lower than then expected returns. In these circumstances, the requirements are perceived to generate numbers that do not reflect economic reality.

In addition, the requirements are considered to be too costly and complex to apply in those circumstances.

- 2.17 On the other hand, the existing requirements can also result in not recognising a net pension liability when the plan assets would be expected to be insufficient to cover the payments to the employee at retirement for the service provided to date. For a pension plan within the scope of this project under which an employee's service in later years will not lead to a materially higher level of benefit than in earlier years, such a scenario could happen:
- (a) When a minimum guaranteed return is higher than the actual return and the discount rate is higher than the minimum guaranteed return. This could be the case if the plan assets consist of government bonds. In this scenario, the plan assets will generate a return that is lower than the minimum guaranteed return. At retirement, the final benefit entitlement will thus exceed the fair value of the plan assets.
 - (b) When the actual return in the past has been higher than the minimum guaranteed return, but the minimum guaranteed return over the total expected period of service is expected to be higher than the total actual return. In such cases, the measurement of the pension obligation is based on the minimum guaranteed return and may thus be lower than the fair value of the plan assets.
- 2.18 In both cases, the asset ceiling will result in the pension liability being measured at nil. However, this may not reflect the fact that it is not expected that the plan assets will be sufficient to finance the final benefit entitlement.

The IASB's activities

- 2.19 Currently, the IASB considers a feasibility project on whether it would be possible to eliminate inconsistencies in the measurement of pension benefits that depend on asset returns. The IASB is seemingly only investigating an approach where the expected asset returns are capped at the level of the discount rate for the obligation (i.e. high quality corporate bond rate). This approach is illustrated in detail as the capped asset return approach. The scope of the IASB project is narrower than the scope of this Discussion Paper in terms of approaches explored.
- 2.20 The IASB is currently gathering evidence to help decide whether to develop proposals to make a narrow-scope amendment to IAS 19 for pension benefits that depend on asset returns.
- 2.21 Prior to this, the IASB has done some research on pension plans. In 2015, the IASB staff gathered information about trends in pension plans to assess whether the IASB should consider addressing the issues about contribution-based promises and other features that arise in 'hybrid plans'⁶. As noted above, one of findings was that hybrid plans are as common as traditional defined benefit plans and pure defined contribution plans in the EEA countries. Other key findings were:

⁶ Note that the IASB did not define the term 'hybrid plans'. They mentioned that 'hybrid plans' intended to include plans that incorporate features of both defined contribution and defined benefit plans (IASB staff paper 15A November 2015).

- (a) Hybrid plans exist or may be increasing outside Europe in jurisdictions such as Canada, Mexico and South Africa;
- (b) There is a global trend of a decrease in traditional defined benefit plans and an increase in defined contribution plans and hybrid plans. In particular, there is a significant trend of transition from defined benefit plans to defined contribution plans in the UK, the US and Japan; and
- (c) In some jurisdictions (e.g. China, India, Singapore, Indonesia, Turkey and Spain), pure defined contribution plans are predominant.

2.22 In 2004, the IFRS Interpretations Committee ('IFRS IC') issued a Draft Interpretation D9 *Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions*, to provide guidance on how to apply the requirements of IAS 19 to an employee benefit plan with a promised return on actual or notional contributions.

2.23 The model in the Draft Interpretation D9 required entities to measure benefits with a variable return at the fair value of the underlying reference assets and those with a fixed return using the guidance for defined benefit plans in IAS 19. The liability would then be measured at the higher of those two amounts.

2.24 However, the IFRS IC removed this project from its agenda because it was unable to reach a consensus on a suitable scope for an amendment that would both:

- (a) Improve the accounting for a sufficient population of plans such that the benefits would exceed the costs; and
- (b) Limit any unintended consequences that would arise from making an arbitrary distinction between otherwise similar plans.

CHAPTER 3: ASSUMPTIONS OF ILLUSTRATIVE EXAMPLE AND IAS 19 APPLICATION

Case description and assumptions

- 3.1 Chapter 4 *Alternative approaches* will describe the following approaches that could potentially solve the issues with the current requirements in IAS 19 that were identified above in paragraphs 2.14 to 2.18:
- (a) The Capped Asset Return approach;
 - (b) The Fair Value Based approach; and
 - (c) The Fulfilment Value approach.
- 3.2 The description of the various approaches will be accompanied by illustrations showing the effects on a simplified case. This chapter describes the assumptions used in the case. This chapter also illustrates the application of defined benefit accounting under IAS 19 to the case.

Terms of the plan

- 3.3 In the simplified case chosen, the terms are such that each year, Entity X makes a basic contribution to the employee's pension account. In the first five years of employment, the basic contribution is 0.5% of the salary for the part of the salary falling below a given salary threshold. For the part of the salary that is higher than the threshold, the contribution is 2.5%. After the first five years, the percentages change to 1% and 5%, respectively.
- 3.4 The salary threshold is initially set at 50 000 CU and is adjusted each year based on the annual inflation rate.
- 3.5 The employee can make a supplementary contribution, which cannot exceed 30% of the employee's gross salary for the year. Entity X makes an additional matching contribution corresponding to the supplementary contribution made by the beneficiary as long as the matching contribution does not exceed the basic contribution. Entity X will not match supplementary contributions exceeding the basic contribution. For the purpose of the example, the employee's contribution is always equal to the employer's basic contribution.
- 3.6 The pension account is held by Entity X's pension fund. Entity X decides how the funds are invested. The final benefit entitlement is settled just after the end of Year Eleven. If the beneficiary dies before retirement, the benefits are paid to the entitled heir.
- 3.7 Entity X guarantees a minimum return of 5.5% p.a., accumulated over the entire service period. The final benefit entitlement is therefore the total contributions plus the higher of the actual return on the plan assets and the minimum guaranteed return.
- 3.8 The contributions to the plan are paid at the end of the year.

Financial assumptions

- 3.9 Expected return assumptions are based on published return assumptions for US public pension plans⁷. The table below shows that in the first years, it is expected that the return will be 8% per year and would increase to 8.5% in the later years. However, that expectation is later revised, and it is instead expected that the return will start to decline.
- 3.10 The actual return is based on the return of the United Nations Joint Staff Pension Fund⁸, which is a large US pension fund for which return data is available. For Year Eleven (which corresponds to year 2017) the return of Financial Year Ten (2016) is reused.

Financial year - Asset rates											
Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11
8.0%	13.9%	13.9%	13.9%	13.9%	13.9%	13.9%	13.9%	13.9%	13.9%	13.9%	13.9%
8.0%	8.0%	-24.9%	-24.9%	-24.9%	-24.9%	-24.9%	-24.9%	-24.9%	-24.9%	-24.9%	-24.9%
8.0%	8.0%	8.0%	20.2%	20.2%	20.2%	20.2%	20.2%	20.2%	20.2%	20.2%	20.2%
8.0%	8.0%	8.0%	8.0%	10.3%	10.3%	10.3%	10.3%	10.3%	10.3%	10.3%	10.3%
8.0%	8.0%	8.0%	8.0%	8.0%	-3.9%	-3.9%	-3.9%	-3.9%	-3.9%	-3.9%	-3.9%
8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	12.7%	12.7%	12.7%	12.7%	12.7%	12.7%
8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	7.5%	15.5%	15.5%	15.5%	15.5%	15.5%
8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	7.5%	7.0%	3.2%	3.2%	3.2%	3.2%
8.5%	8.5%	8.0%	8.0%	8.0%	8.0%	7.5%	7.0%	6.5%	-1.0%	-1.0%	-1.0%
8.5%	8.5%	8.0%	8.0%	8.0%	8.0%	7.5%	7.0%	6.0%	6.0%	5.2%	5.2%
8.5%	8.5%	8.5%	8.0%	8.0%	7.5%	7.0%	6.5%	6.0%	5.5%	5.0%	5.2%

- 3.11 The discount factor – the return on high quality corporate bonds is based on the US Treasury High Quality Bond Yield Curve⁹. The table below shows the interest rate per year used to discount the lump-sum amount to be paid at the end of Year Eleven to the end of the various financial years:

Financial year											
	0	1	2	3	4	5	6	7	8	9	10
Discount	5.45%	5.89%	6.97%	4.14%	3.88%	3.21%	1.54%	1.21%	1.59%	1.69%	1.67%

- 3.12 Based on the assumptions, the cumulative return at the end of the plan, i.e. Year Eleven, will be lower than the minimum guaranteed return. Therefore, the entity will need to pay an additional contribution to cover the shortfall of 651 CU. It is assumed that the shortfall is paid at the settlement date.

Salary and service assumptions

- 3.13 The beneficiary is expected to work for Entity X for eleven years. The initial salary is 57 000 CU and is expected to increase every year based on the annual inflation rate. In addition, every second year the salary will increase by approximately 2.1% (in addition to the inflation). The additional increase is therefore expected to apply for the salary for Year Three.

⁷ See: <http://www.pionline.com>, <https://www.twosigma.com>, and <http://www.nasra.org>.

⁸ Source: <http://imd.unjspf.org>.

⁹ The data used is available here: <https://www.treasury.gov>. The discount factor used in Financial Year One is the High Quality Corporate Bond rate from December 2006 for bonds with a maturity of ten years. Linear interpolation is used to estimate the interest rate on bonds with a maturity of 1 to 9 years.

	Financial year									
	1	2	3	4	5	6	7	8	9	10
Inflation	1.30%	1.50%	2.00%	3.00%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%
Increase		2.10%		2.10%		2.10%		2.10%		2.10%

- 3.14 The beneficiary makes supplementary contributions equal to the maximum amount Entity X will match (the basic contribution). In the first three years, the employee's and entity's contributions amount to:

EUR	Year One	Year Two	Year Three
Employee contribution	425	431	467
Entity X's contributions	850	861	935

Additional assumptions for the Fair Value Based approach

- 3.15 For the purpose of illustrating of the Fair Value Based approach (see paragraphs 4.22 to 4.43 below), EFRAG assumed that the fair value of the pension obligation would be the sum of the fair values of its two components i.e. the total contributions made increased by the accumulated returns and the minimum guaranteed return related to the contributed amounts.
- 3.16 The estimation of the fair value of the first component assumes that the own credit risk of Entity X is negligible. Consequently, the fair value of that obligation is estimated at the fair value of the plan assets (or payable contributions).
- 3.17 The formula used to estimate the fair value of minimum return guarantee is based on a probability based approach and derives from Black and Scholes valuation model. The model requires estimating several rates, which have been assumed at the following levels:
- (a) Risk free rate: 0.25% - this rate is assumed not to change during the term of the plan;
 - (b) Standard deviation of the plan asset returns: 11.76%. This figure is based on the variation of the returns of the United Nations Joint Staff Pension Fund. The standard deviation is assumed not to change during the term of the plan.

Additional assumptions for the Fulfilment Value approach

- 3.18 When computing the pension obligation under the Fulfilment Value approach, it is necessary to consider both inflows to and outflows from the pension fund. Inflows relate to both expected future employer and employee contributions and outflows are related to the final benefit entitlement.
- 3.19 The formula used to estimate the fair value of minimum return guarantee is based on a probability based approach and derives from Black and Scholes valuation model. The fair value is remeasured at each reporting period (see the assumptions in paragraph 3.17 above). The value of the minimum return guarantee is based on the accumulated employer and employee contributions that have been made. It does not reflect expected future contributions. Therefore, at Year Zero, when no contributions have been made, the value of the minimum return guarantee is zero.
- 3.20 The calculation of the fair value of the minimum return guarantee for the Fulfilment Value approach is different from that of the Fair Value Based approach. The calculation under

the Fulfilment Value approach takes into account the entity's expectations of return on plan assets and, therefore, takes into consideration the probability of actual return being lower than both the expected return and the guaranteed return.

Limitations in the illustrative example

- 3.21 The illustrative example has some limitations compared to a real life pension plan. In a typical pension plan, there would be many employees and there could potentially be plan amendments or curtailments occurring. However, in the illustrative example, there is only one employee. There is no plan amendment or curtailment and therefore no past service cost.
- 3.22 The employee is initially assumed to work for eleven years and the final benefit entitlement is immediately paid at the end of the period of service. There is no revision in the biometric assumptions. In real life, the calculation would be impacted by changes in assumptions about mortality and employee turnover.
- 3.23 Furthermore, benefits under a defined benefit plan may be subject to vesting conditions, such as the completion of a service period. In the illustrative example, the likelihood of meeting the vesting conditions has not been considered.

Application of the IAS 19 model for defined benefit plans

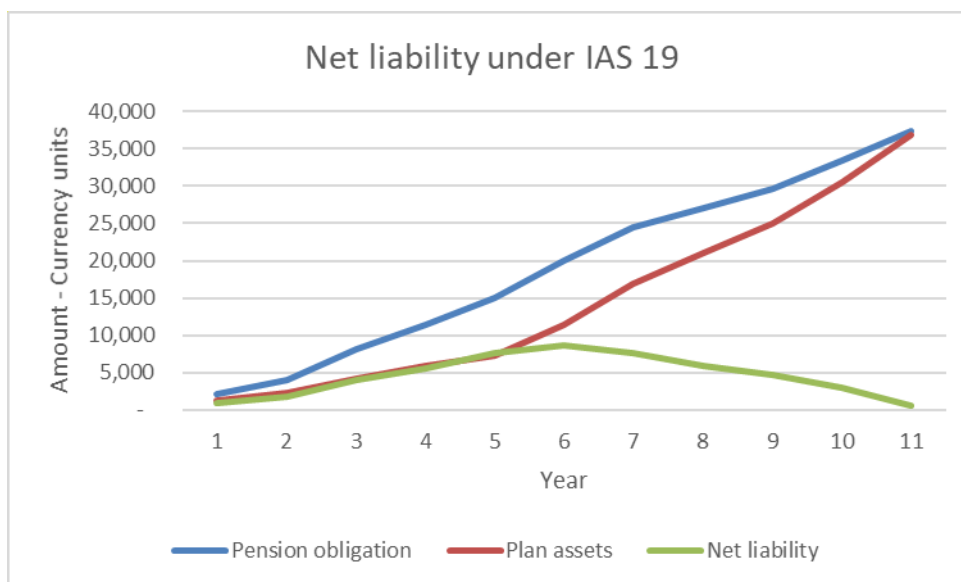
- 3.24 As appeared above, the pension scheme in the case example runs for 11 years. In order to make the illustration of the various approaches to account for pensions as clear as possible, this Discussion Paper focuses on providing figures for only one of the years. Year Three has been chosen. In addition to the description of the application of the IAS 19 model for defined benefit plans and the alternative approaches, graphs are provided to illustrate the net pension liability position each year and amounts recognised each year in the statement of comprehensive income.

Statement of financial position

- 3.25 When the requirements included in IAS 19 for defined benefit plans are applied to the example in the case, the Year Three net pension liability is as follows:

	Currency units
Plan assets	4 105
Pension obligation	8 073
Net pension liability	<u>3 968</u>

- 3.26 The graph below shows the actual net pension liability that would have been recognised in the statement of financial position each year under IAS 19.



3.27 In the above graph, the pension obligation is higher than the plan assets in all years. This results from IAS 19 requirement to apply backload correction (i.e. to straight-line the recognised annual current service cost). Moreover, this effect increases because the expected return rate or the minimum guaranteed return rate (whichever is higher) is higher than the discount rate. From Year Nine to Year Eleven, the pension obligation is calculated based on the minimum guaranteed return.

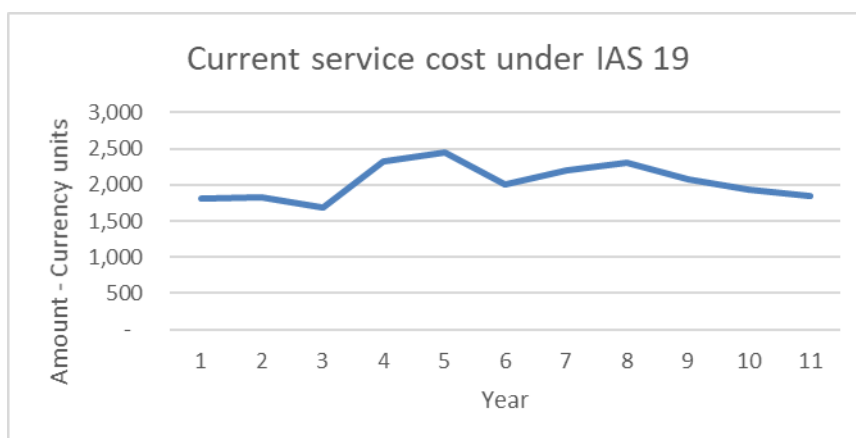
Pension income and costs in comprehensive income

Current service cost

3.28 In Year Three of the example, the current service cost under IAS 19.125 would be as follows:

Currency units	
Current service cost	1 686

3.29 The graph below shows the actual current service cost that would be recognised in profit or loss each year under IAS 19:



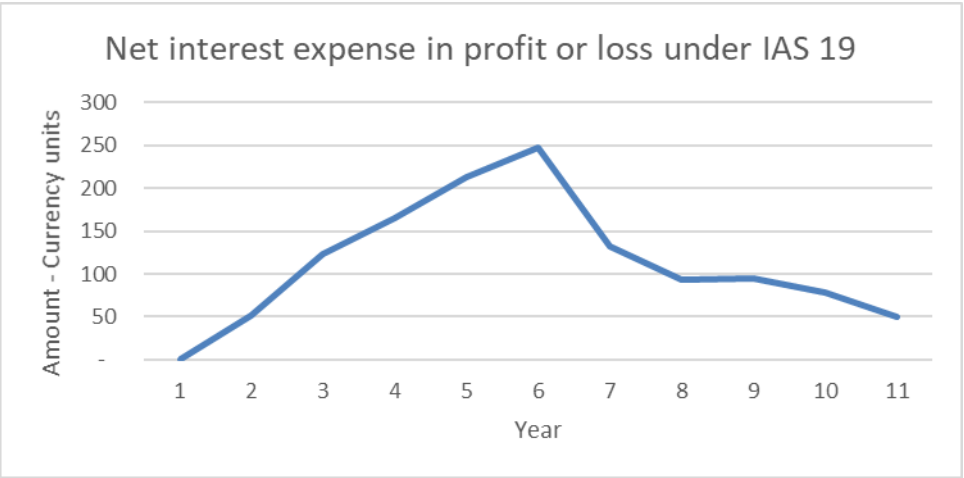
- 3.30 As can be seen from the above graph, the current service cost is not linear due to the yearly changes in actual and expected assets returns and discount rates. This impacts the projection of the estimated final benefit entitlement and therefore the current service cost. In the example, benefits are attributed on a straight-line basis (in the following termed 'backload correction'). This is because, under the plan considered an employee's service in later years will lead to a materially higher level of benefit than in earlier years (IAS 19.70).

Other pension income and costs

- 3.31 In Year Three, the following elements are recognised in the statement of comprehensive income (positive amounts are income while negative amounts are expenses):

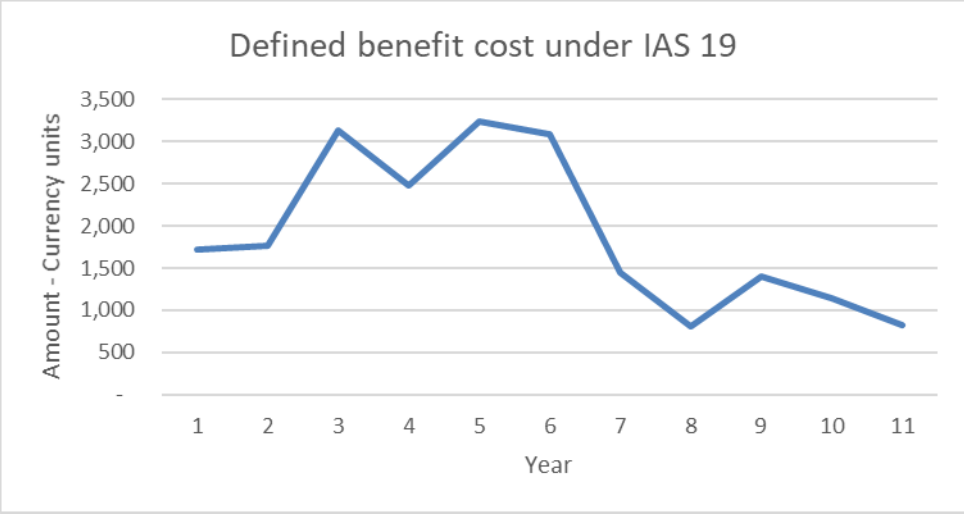
	Currency units	Currency units
Profit or loss:		
Current service cost		-1 686
Return on plan assets	157	
Interest expense	-281	
Net interest expense		-124
OCI:		
Remeasurement relating to return on plan assets		298
Remeasurement relating to actuarial gains and losses		-1 613
Total comprehensive income		-3 125

- 3.32 The return on plan assets is the income from the assets each year using the discount rate at the start of the period. [IAS 19 paragraph 125]
- 3.33 The interest expense for the pension obligation is computed by multiplying the opening balance of the pension obligation by discount rate at the start of the period. [IAS19 paragraph 123]
- 3.34 The remeasurement relating to return on plan assets is the difference between the interest income applying actual return on plan assets and the return on plan assets recognised in profit or loss. [IAS 19 paragraph 125]
- 3.35 The remeasurement relating to actuarial gains and losses results from decreases and increases in the opening balance of the defined benefit obligation due to changes in the estimated final benefit entitlement and the effect of changes in the discount rate. [IAS 19 paragraphs 127-128]
- 3.36 The graph below shows the actual net interest (i.e. the net amount of interest income from the plan assets and interest expense from the pension obligation) that would have been recognised in profit or loss each year under IAS 19:



3.37 From Year One to Year Six, each year the net pension liability increases and therefore the net interest expense also increases. As from Year Seven, the net interest expense gradually decreases. This is mainly due to a decrease, by more than 50%, in the discount rate in Year Six.

3.38 Furthermore, the graph below shows how the defined benefit cost would be under IAS 19.



CHAPTER 4: ALTERNATIVE APPROACHES

Capped Asset Return approach

The approach

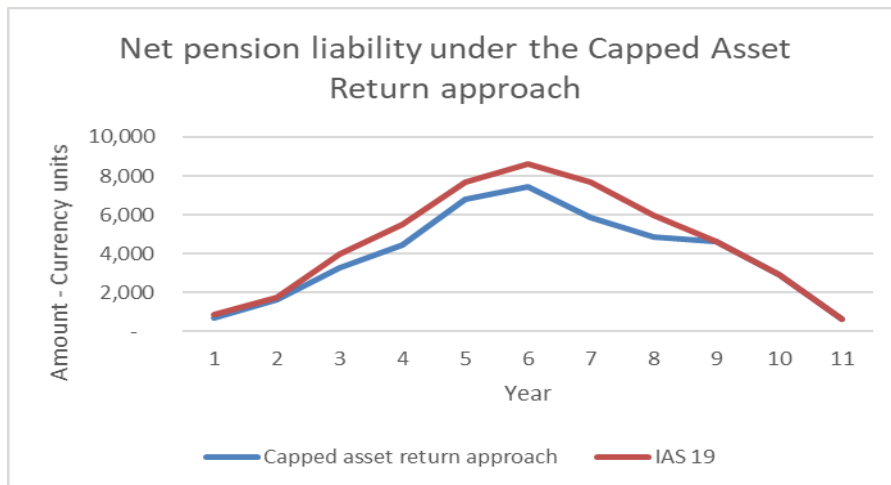
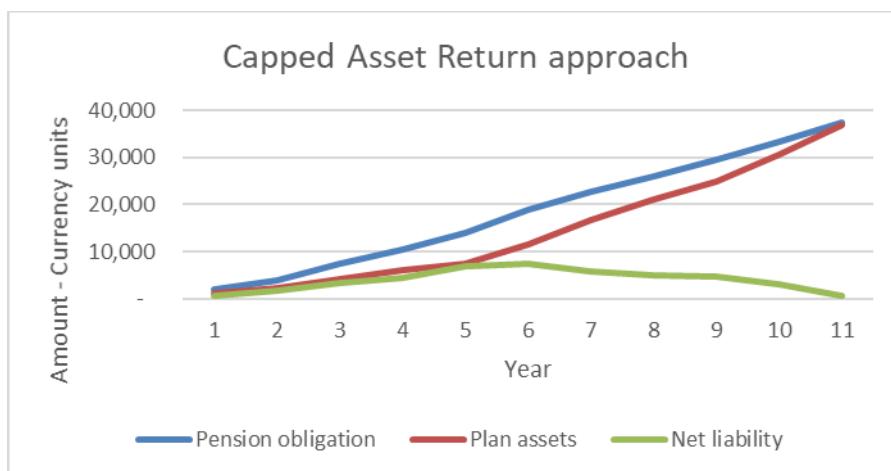
- 4.1 One main criticism of the application of IAS 19 to pension plans with an asset-return promise is that benefits are projected using the expected return rate and then discounted using the yields on high quality corporate bonds.
- 4.2 A relatively simple solution would be to cap the expected asset return rate to the high quality corporate bond rate (the discount rate).
- 4.3 Under this approach, the entity first projects the final benefit entitlement using the capped rate and compares this amount to the final benefit entitlement based on the minimum guaranteed return. The higher of these two amounts is used to determine the pension obligation at the reporting date and the service cost. Capping the expected return rate potentially leads to a lower nominal value of the final benefit entitlement compared to IAS 19. Consequently, a lower amount will be attributed to periods of service in accordance with paragraph 70 of IAS 19, and current service cost will be lower. Apart from the above, the computation is similar to that under IAS 19.
- 4.4 Instead of capping, the expected return could be set equal to the discount rate. The results of such an approach would be similar to capping when the expected returns exceed the high quality corporate bond rate, but would be different when the expected returns are lower.

Statement of financial position

- 4.5 In Year Three, the net pension liability would be as follows under the Capped Asset Return approach:

	Currency units
Plan assets	4 105
Pension obligation	7 386
Net pension liability	<u>3 281</u>

- 4.6 The graphs below show the actual net pension liability recognised in the statement of financial position for the Capped Asset Return approach in comparison with IAS 19.



- 4.7 The graphs illustrate that the trend of the net pension liability year by year under the Capped Asset Return approach is similar to that under IAS 19. However, the net pension liability under the Capped Asset Return approach is lower than that under IAS 19 in most years due to the final expected benefit entitlement being lower, as explained below, and the plan asset amount being the same under both IAS 19 and the Capped Asset Return approach.
- 4.8 The pension obligation is computed in the same way under the Capped Asset Return approach as under IAS 19. However, there is a difference in the rate used to project the asset returns in order to compute the estimated final benefit entitlement the employee will receive upon retirement. Under IAS 19, the expected asset return rate is used to project the asset returns, which is higher than the discount rate used to cap the asset returns under the Capped Asset Return approach. As a result, the asset return amount included in the estimated final benefit entitlement is lower for the Capped Asset Return approach compared to IAS 19. Consequently, as the same discount rate is used, the pension obligation of the former approach is lower than the latter one.
- 4.9 From Year Nine till Year Eleven, the value of the minimum guaranteed return becomes effective. Consequently, the net pension liability is computed based on the minimum

guaranteed return for both approaches, thereby resulting in the same amounts for both the Capped Asset Return approach and IAS 19.

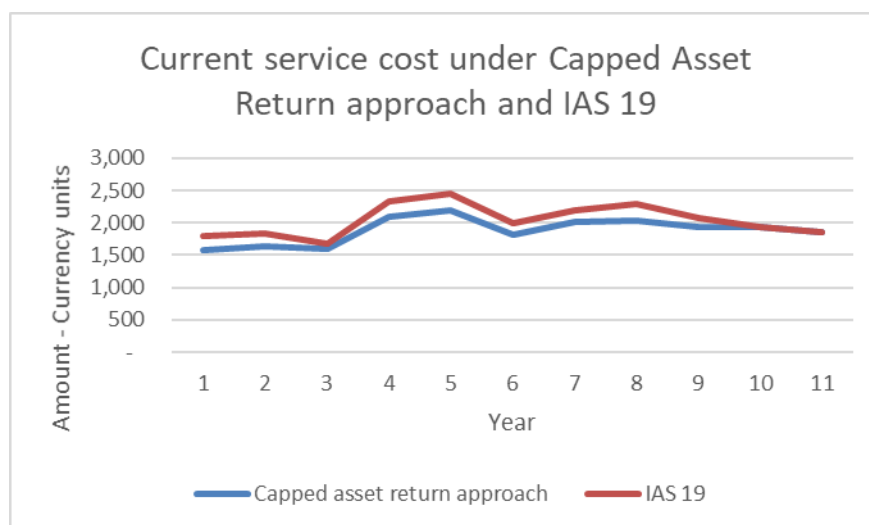
Pension income and costs in comprehensive income

Current service cost

- 4.10 The methodology for computing the current service cost under the Capped Asset Return approach is the same as under IAS 19. In Year Three, it would be as follows:

Currency units	
Current service cost:	1 596

- 4.11 The graph below shows the current service cost that would be recognised in profit or loss each year for both the Capped Asset Return approach and IAS 19:



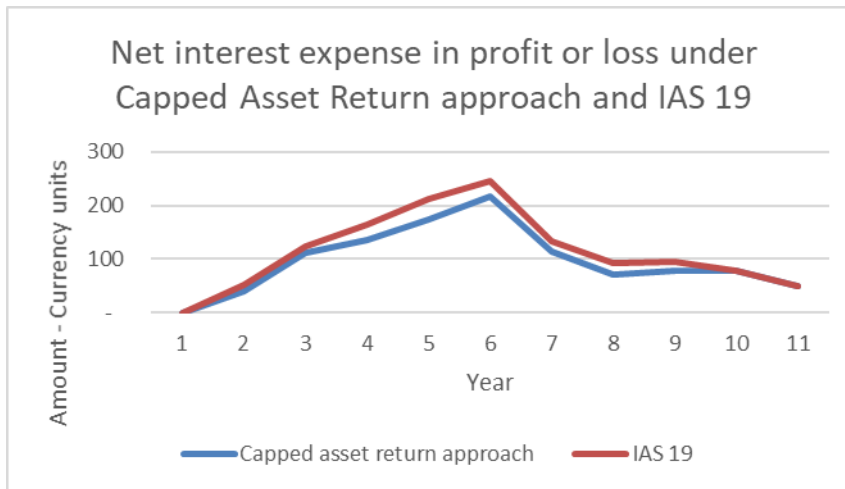
- 4.12 As can be seen from the above graphs, the current service cost under the Capped Asset Return approach is lower than that under IAS 19 even though the computation methodology is the same. The current service cost is a portion of the final benefit entitlement. Based on paragraph 4.8, the estimated final benefit entitlement is lower under the Capped Asset Return approach compared to IAS 19. Consequently, the current service cost is also lower for the former approach compared to the latter one.

Other pension income and costs

- 4.13 In Year Three, the following elements would be recognised in the statement of comprehensive income following the approach (positive amounts are income while negative amounts are expenses):

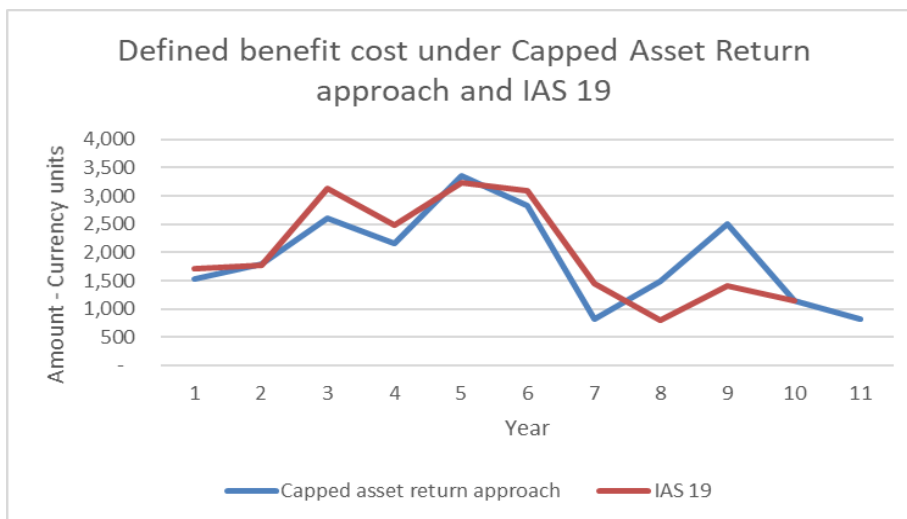
	Currency units	Currency units
Profit or loss:		
Current service cost		-1 596
Return on plan assets	157	
Interest expense	-269	
Net interest expense		-112
OCI:		
Remeasurement relating to return on plan assets		298
Remeasurement relating to actuarial gains and losses		-1 197
Total comprehensive income		-2 607

- 4.14 The return on plan assets is the same as under IAS 19, i.e. income from the assets each year using the discount rate at the start of the period.
- 4.15 The interest expense for the pension obligation is computed by multiplying the opening balance of the pension obligation by the discount rate at the start of the period. The interest expense is smaller than under IAS 19 because of the lower pension obligation under the Capped Asset Return approach.
- 4.16 The remeasurement relating to return on plan assets is the same as under IAS 19, i.e. it is the difference between the interest income applying actual return on plan assets and the return on plan assets recognised in profit and loss.
- 4.17 The remeasurement relating to actuarial gains and losses comprises the same components as under IAS 19, i.e., it results from decreases and increases in the opening balance of the defined benefit obligation due to changes in estimated final benefit entitlement and the effect of changes in the discount rate. In the example, the actuarial loss is significantly lower than under IAS 19. This is due to the significant decrease in the discount rate. Under IAS 19, the decrease in the rate affects the loss when the nominal value of the estimated final benefit entitlement – which is not affected by the change in the rate – is discounted at a much lower rate. This results in a significant increase in the value of the pension obligation. Under the Capped Asset Return approach the change in the discount rate also decreases the value of the estimated final benefit entitlement. The decrease in the estimated final benefit entitlement partially offsets the effect of the lower discount rate.
- 4.18 The graph below shows the actual net interest (i.e. the net amount of interest income from the plan assets and interest expense from the pension obligation) that would be recognised in profit or loss each year for both the Capped Asset Return approach and under IAS 19:



4.19 Both under the Capped Asset Return approach and IAS 19, the net interest expense recognised in profit or loss is computed based on the discount rate. However, since the net pension liability under the Capped Asset Return approach is lower than that under IAS 19, the net interest expense computed is also lower under the Capped Asset Return approach.

4.20 The graph below shows the defined benefit cost under the Capped Asset Return approach compared to IAS 19:



4.21 The difference between the Capped Asset Return approach and IAS 19 in Year Nine in the graph above can be explained by the fact that the estimated final benefit entitlement is calculated based on the minimum guaranteed return in that year. The pension obligation is therefore the same under both the Capped Asset Return approach and IAS 19. In the previous period, the pension obligation is higher under IAS 19 than under the Capped Asset Return approach. Hence, the adjustment under the IAS 19 approach is higher than under the Capped Asset approach.

Fair Value Based approach

The approach

- 4.22 Measuring both plan assets and the pension obligation at fair value would reduce or remove accounting mismatches. Moreover, it would better reflect the linkage between the plan assets and the pension obligation.
- 4.23 There are, however, many ways in which such an approach could be applied. A discussion on the approach used in this paper, is provided below. In this paper, the value of the defined benefit obligation is measured at a sum of the fair value of contributions and the return accumulated to date, and the fair value of the minimum return guarantee related to those contributions.
- 4.24 The Fair Value Based approach explored in this Discussion Paper separately reflects the total contributions to date and accumulated returns (first component) and the value of the minimum return guarantee (second component). In other words, it bifurcates the 'higher of' promise and accounts for it as a separate financial instrument. Moreover, the fair value is calculated based on the plan formula i.e. on already contributed amounts together with related returns, which are guaranteed to be at least equal to the minimum guaranteed return.
- 4.25 In the calculation of the fair value of the first component, own credit risk and the likelihood of modifications or curtailments are excluded. IFRS 13 *Fair Value Measurement* defines fair value of a liability as the price that would be paid to transfer the liability in an orderly transaction. Accordingly, a 'pure' fair value measurement should, for example, take into account the likelihood of any possible modification to the terms of the plan. However, in its Discussion Paper *Preliminary Views on Amendments to IAS 19* (March 2008), the IASB argued that a measurement, that would reflect possible changes in the plan, would misrepresent the entity's obligation.
- 4.26 In the illustration, the fair value of the obligation related to the contributed amounts and any actual returns, is measured at fair value of the plan assets.
- 4.27 Regarding the second component, the calculation takes into account that the cumulative returns from contributions made in some years could exceed the minimum guaranteed return. These surpluses could be used to offset any deficits between the cumulative returns and the minimum guaranteed returns related to contributions made in other years. The calculation is based on a probability approach and derives from Black and Scholes valuation model.
- 4.28 The elements affecting defined benefit cost in a period would be:
- (a) employer's contributions payable in a period recognised in profit or loss;
 - (b) the increase in the minimum return guarantee's fair value relating to the current period's contributions (employee's and employer's), which would be recognised in profit or loss; and
 - (c) other elements of remeasurements which generally include changes in the fair value of the minimum return guarantee relating to past contributions; in the example, they are presented in profit or loss.

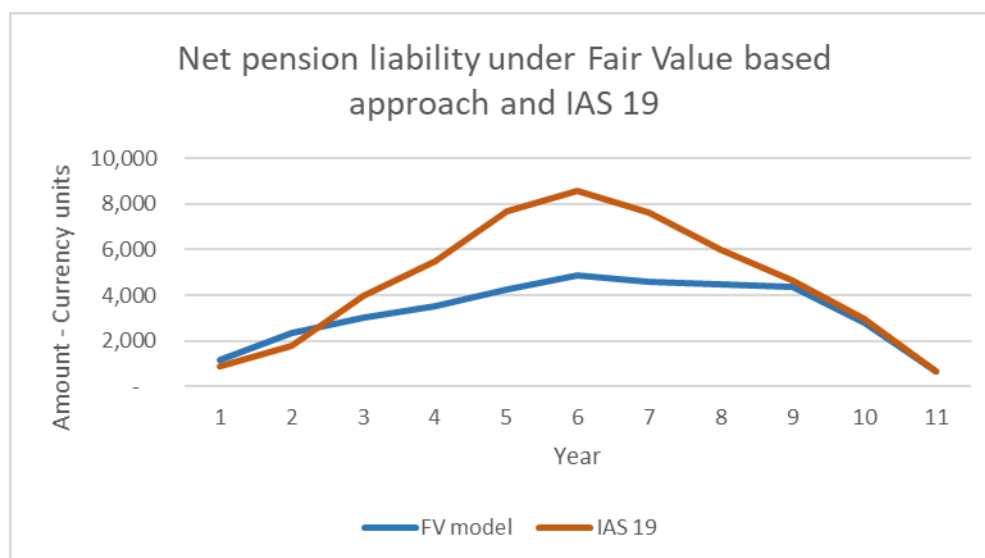
Statement of financial position

4.29 In Year Three, the net pension liability would be as follows:

	Currency units
Plan assets	4 105
Pension obligation	7 144
Net pension liability	<u>3 039</u>

4.30 The pension obligation value would comprise the value of the total contributions made increased by accumulated returns (4 105 CU) and the value of the minimum return guarantee (3 039 CU).

4.31 The graphs below show the actual net pension liability that would be recognised in the statement of financial position in accordance with the Fair Value Based approach and IAS 19, respectively:



4.32 Under the Fair Value Based approach, the actual net pension liability represents only the value of the minimum return guarantee as the first component of the obligation equals the fair value of the plan assets. Under IAS 19, the pension obligation is, partially because of the backload correction, higher than the plan assets in the earlier years.

Pension income and costs in comprehensive income

Current service cost

4.33 Under the approach current service cost includes:

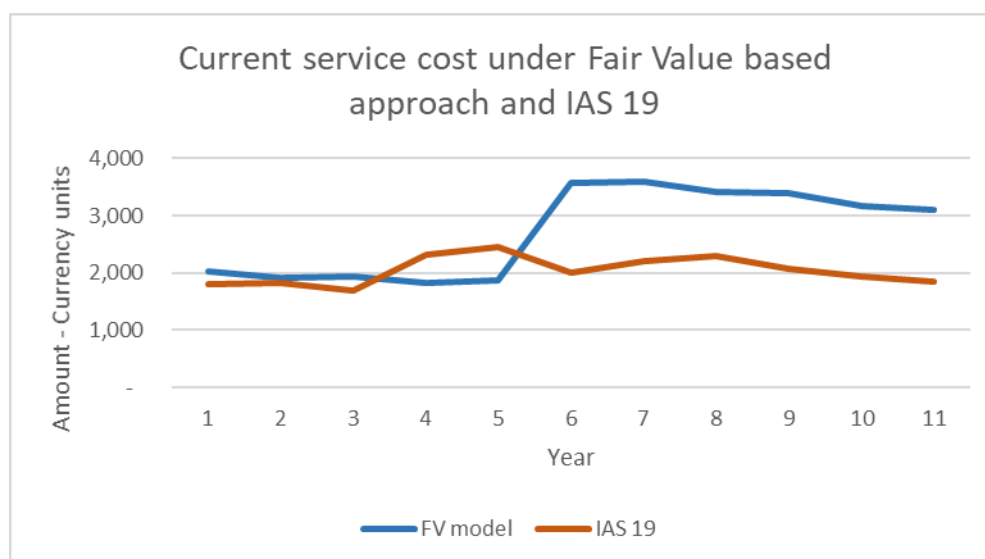
- Employer's contribution for the period based on which the return would be determined; and
- The fair value of the minimum return guarantee linked to the employer's and employees' contributions for the period.

4.34 EFRAG considers that the mentioned components of current service cost reflect the additional salary that the entity would have to pay to the employee for him/her to be able to purchase a pension plan with the same conditions. EFRAG deems this to be a good proxy for the value of the employee's service, which cannot be directly measured.

4.35 In Year Three, the current service cost would be as follows:

Currency units	
Current service cost:	1 939
Employer contribution for the period	935
Value of the guarantee	1 004

4.36 The graphs below show the actual current service cost that has been recognised in profit or loss each year for both the Fair Value Based approach and under IAS 19.



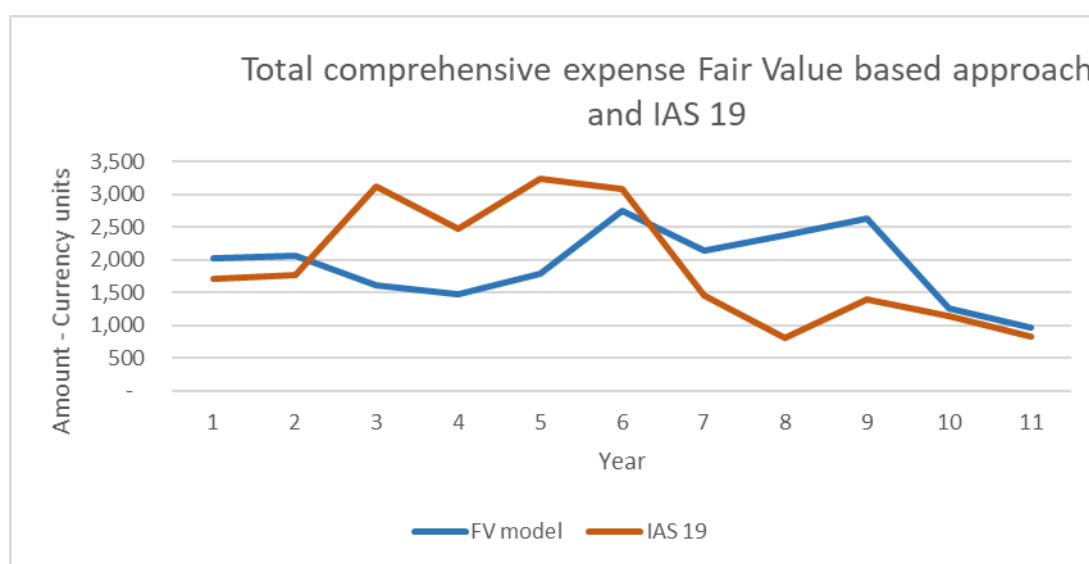
4.37 As can be seen from the graphs, under the Fair Value Based approach, the current service cost increases in Year Six. This is mainly due to increases in the contribution level. Under IAS 19 the final benefit entitlement is evenly allocated to service years.

Other pension income and costs

4.38 In Year Three, the following are elements to be recognised in the statement of comprehensive income (positive amounts are income while negative amounts are expenses):

Currency units	
Profit or loss:	
Current service cost	-1 939
Other remeasurements	+328
Total comprehensive income	<u><u>-1 611</u></u>

- 4.39 Other remeasurements comprise the remeasurement of the minimum return guarantee in regard to past employer's and employee's contributions.
- 4.40 There could be two views about the accounting for the remeasurement of the minimum return guarantee. One view is that this amount should be presented in profit or loss. Several existing IFRS Standards require presentation of changes in fair value of assets and liabilities in profit or loss. Examples include derivatives (unless they are hedging instruments in a cash flow hedging relationship); equity instruments held for trading and investment properties under IAS 40.
- 4.41 A second view – more in line with the treatment of remeasurements in IAS 19 – is that this amount should be presented in OCI since it is the result of a change in the actuarial assumptions.
- 4.42 The graphs below show the defined benefit cost would be under the Fair Value Based approach compared to IAS 19.



- 4.43 It appears from the graphs that, compared to IAS 19, under the Fair Value Based approach the cost increases in Year Six. This is mainly due to the increase in the level of contributions. The variability of the defined benefit costs under the Fair Value Based approach is due to the time value related to the minimum return guarantee which decreases over time and the remeasurement of the value of minimum return guarantee which increases in the later years because of low actual returns.

Fulfilment Value approach

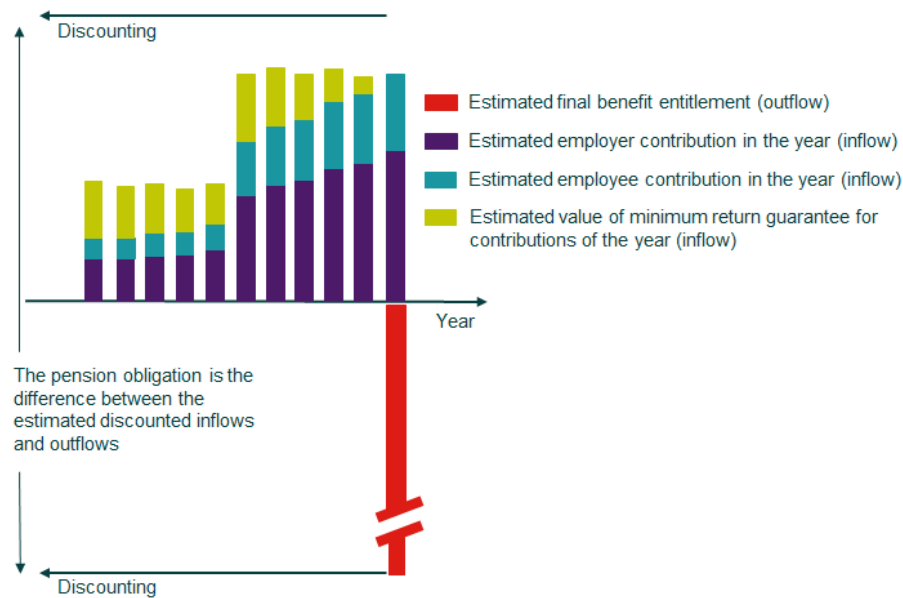
- 4.44 EFRAG has considered that pension plans with an asset-return promise and insurance contracts share a number of characteristics:
- (a) Both obligations may have a long-term duration and therefore there is uncertainty about the amount and timing of the cash flows;
 - (b) Both deliver a benefit promise from the sponsor to the beneficiary;

- (c) 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. In addition, the actuarial assumptions are unbiased; and
 - (d) Some insurance contracts, in addition to insurance coverage, provide the policyholder with a portion of the return of a pool of underlying assets. This participation feature is similar to the asset-return promise.
- 4.45 Therefore, an alternative to the requirements in IAS 19 for the pension plans within the scope of this Discussion Paper could be a Fulfilment Value approach relying on concepts from IFRS 17 *Insurance Contracts*, without being fully aligned to the requirements in IFRS 17.
- 4.46 One fundamental difference between the Fulfilment Value approach considered in this Discussion Paper and IFRS 17 is that the measurement of insurance contracts includes a contractual service margin. This represents the unearned profit that the entity recognises as it provides services. In a pension plan, the entity is receiving services from the employee and does not recognise a profit.

The approach

- 4.47 There are no changes to the measurement of the plan assets compared with IAS 19. They are thus measured at fair value.
- 4.48 The pension obligation includes:
- (a) Fulfilment cash flows which are expected future cash flows, considering the life of the pension plan and these comprise the following:
 - i) Inflows in the form of future contributions made by the employer and the employee. The contributions made by the employer and the value of the minimum return guarantee are used as a proxy to measure the value of future employee services;
 - ii) Expected outflows in the form of the final benefit entitlement and the value of the minimum return guarantee (for all paid contributions to date);
 - (b) The above are discounted to present value using a discount rate that reflects the plan assets because the cash outflows are based on the returns on plan assets.

4.49 The approach is illustrated below for Year 1.



4.50 Unlike IAS 19, no backload correction is applied under the approach. Furthermore, in addition to the components, mentioned in paragraph 4.48 above, a risk adjustment would be required which relates to non-financial risk (i.e. an outflow) and computed separately. Refer to paragraphs 4.56 to 4.57 for more information. In this Discussion Paper example, no risk adjustment is included.

4.51 Expected future cash flows are considered from an entity's perspective. The computation of the cash flows should be unbiased and be probability-weighted (i.e. expected value). If any discretionary contributions are made (e.g. employee contributions), then these would be considered in the probability-weighted computations. These future cash flows are updated each reporting period. In the example in this Discussion Paper, there is only one scenario.

4.52 EFRAG has considered that the service cost should reflect the value of the employee services. Since this cannot be directly measured, the future contributions made by the employer and the value of the guarantee (for all paid contributions) has been used as a proxy. In addition to this, future employee contributions would also be part of the expected inflows as this is an expected cash inflow arising due to the pension plan.

4.53 EFRAG considers that the discount rate for the pension obligation would reflect the return on plan assets because the return on the plan assets affects the pension obligation. However, even though there is a linkage with the plan assets, EFRAG considers that the discount rate for the pension obligation should reflect only relevant factors. That is, the liability discount rate would be consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the pension obligation, in terms of, for example, timing, currency and liquidity.

4.54 For example, an adjustment to the liability discount rate would be made if the duration of the assets is different from the expected duration of the pension obligation. Therefore, the pension obligation discount rate may not be identical to the discount rate of the plan assets. If observable market rates are not available, the entity would need to estimate the appropriate rates.

- 4.55 However, in the example in this Discussion Paper, the return on plan assets has been used to discount to present value the expected inflows and outflows, relating to the pension obligation. The projected unit credit method is not used in this approach.
- 4.56 EFRAG considers that the characteristics of the pension obligation discount rate does not relate to only financial risks but also to non-financial risks. Therefore, a risk adjustment could be included in the measurement and would relate to the uncertainty of the amount and timing, due to these non-financial risks, for an entity to fulfil its pension obligation. For example, there could be uncertainty about mortality assumptions which may affect the amount and timing of the final benefit entitlement. The risk adjustment would be an additional amount on top of the discounted value of expected future cash flows, such that the total is equal to the level of certainty equivalent for that entity with respect to non-financial risks.
- 4.57 EFRAG has not taken these non-financial risks, e.g. risks relating to mortality and employee turnover into account in the example in the case in Discussion Paper because there is only one employee and one scenario up to the end of the pension plan. Therefore, in the example in the Discussion Paper, there is no risk adjustment. However, in general the risk adjustment could convey information to the users about the amount charged by the entity for the uncertainty arising from the non-financial risk about the amount and timing of cash flows. The risk adjustment would be remeasured at each reporting period.
- 4.58 The value of the minimum return guarantee consists of both the intrinsic value and the time value and would form part of the expected future cash flows. This value effectively represents uncertainty relating to financial risk. EFRAG considers that, as stated above, this would also form part of the value of employee service because the entity has guaranteed the employee benefits. It is computed based on employer and employee contributions that have already been made and not on expected future contributions. The implication of not considering the value of the minimum return guarantee for future contributions is that the benefits are not allocated on a straight-line basis. The value of the minimum return guarantee is remeasured at the end of each reporting period. In the example in this Discussion Paper, the value of the minimum return guarantee is included in the cash flows rather than being an adjustment to the discount rate. Furthermore, in this example, for simplicity, the value of the minimum return guarantee has been determined on a stand-alone basis. In practice it would be incorporated in the probability-weighted calculations taking into consideration a full range of possible outcomes.
- 4.59 Further explanations of the approach are provided below when illustrating the effects on the case example included in this Discussion Paper.

Variations of the Fulfilment Value approach considered

- 4.60 Some variations of the Fulfilment Value approach that could be considered are:
- (a) Considering only the employee contributions as inflows and not including the employer contributions. The version of the approach illustrated in this Discussion Paper is based on the view that the inflows should also include the value of the service received from the employee, which could be reasonably approximated by the employer contributions as explained in paragraph 4.52 above.
 - (b) An approach where at the end of each reporting period, the liability includes the value of the guarantee based not only on the contributions paid, but on the total contributions and allocated on a straight-line basis to the period. The latter

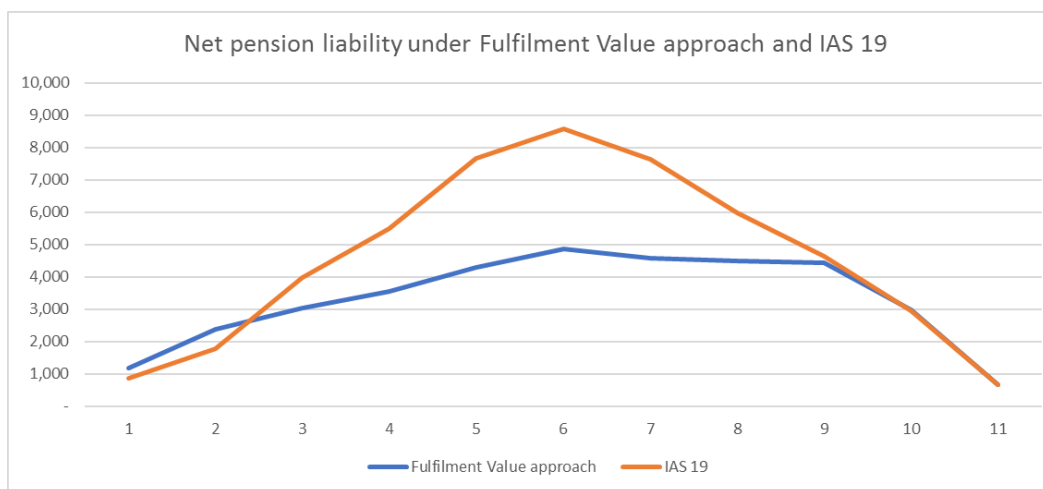
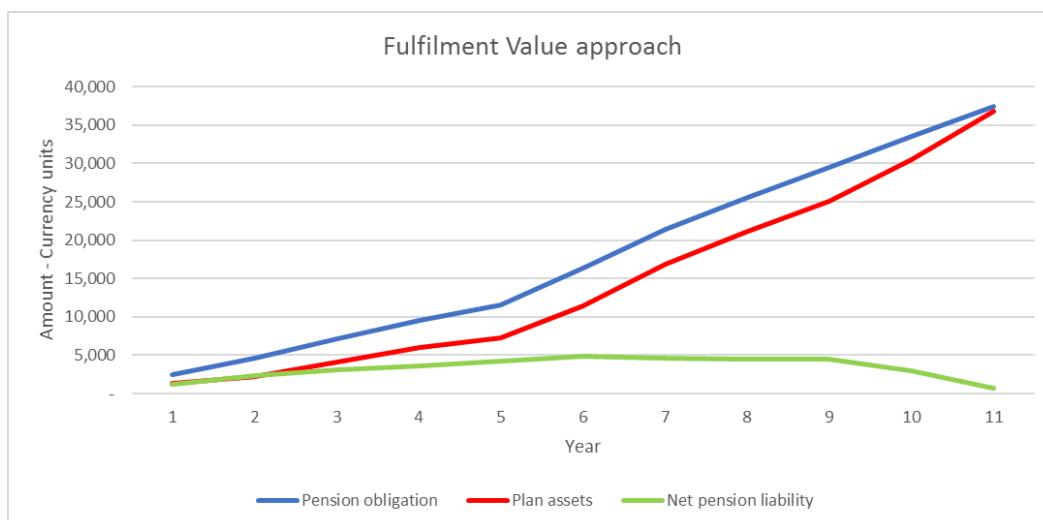
computation would likely be relatively simpler and less complex compared to computing the value of the guarantee over the life of the pension plan, and allocating the amount to the years of service.

Statement of financial position

4.61 In Year Three, the net pension liability under the Fulfilment Value approach would be as follows:

	Currency units
Plan assets	4 105
Pension obligation	7 144
Net pension liability	3 039

4.62 The first graphs below show the net pension liability and its components recognised in the statement of financial position for the Fulfilment Value approach. The second graphs compare the net pension liability of the Fulfilment Value approach to IAS 19.



- 4.63 In the example, since the same discount rate is used for both the plan assets and the pension obligation, the net pension liability under the Fulfilment Value approach is effectively the value of the minimum return guarantee. Again, the discount rate for both the plan assets and the pension obligation may not be the same. Refer to explanation in paragraphs 4.53 to 4.57.
- 4.64 The net pension liability under the Fulfilment Value approach is lower than that under IAS 19. This is because of the lack of the backload correction and the use of the expected return rate of the plan assets when discounting the pension obligation. In addition, the net pension liability under the Fulfilment Value approach would also include the value of the minimum return guarantee.

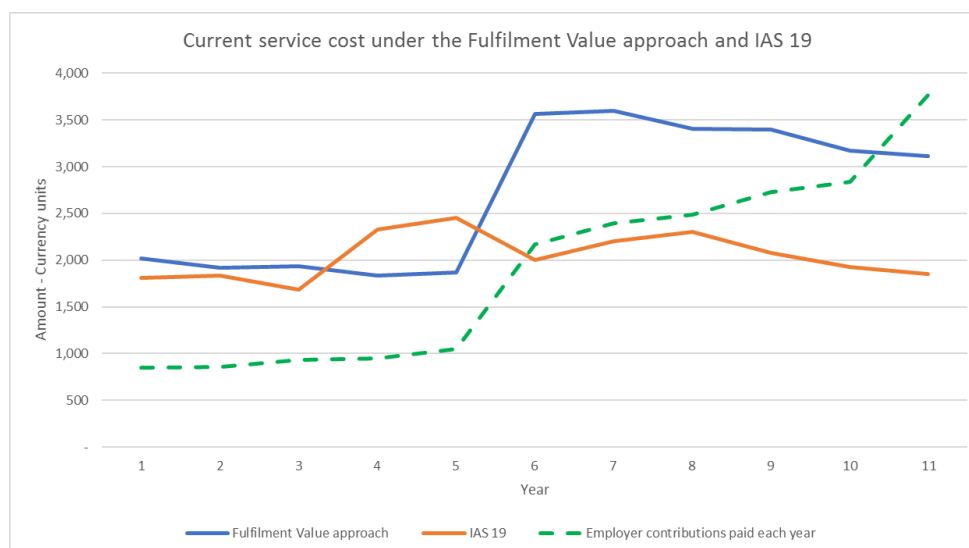
Pension income and costs in comprehensive income

Current service cost

- 4.65 The current service cost per year under the Fulfilment Value approach, consists of:
- the contributions made by the employer in each reporting period; and
 - the fair value of the minimum return guarantee on the asset return-promise relating to both employer and employee contributions made in each reporting period.
- 4.66 In Year Three, the current service cost would be as follows:

Currency units	
Current service cost:	1 939
Employer contribution for the period	935
Value of the minimum return guarantee	1 004

- 4.67 The graphs below show the actual current service cost that would be recognised in profit or loss each year for both the Fulfilment Value approach and under IAS 19:



- 4.68 As can be seen from the graphs, the current service cost from the Fulfilment Value approach mainly follows the employer's contributions which increase over time.

- 4.69 The main difference with IAS 19 is the lack of the backload correction and the inclusion of the value of the minimum return guarantee under the Fulfilment Value approach. In addition, under the Fulfilment Value approach, changes in the discount rate would not affect the service cost.

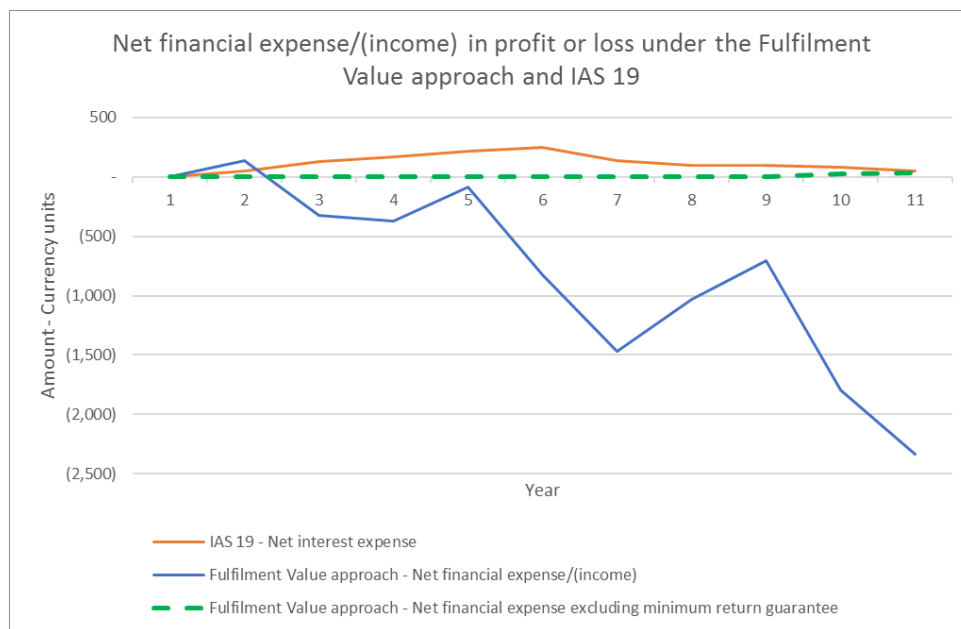
Other pension income and costs

- 4.70 The following are elements that would be recognised in the statement of comprehensive income in Year Three (positive amounts are income while negative amounts are expenses):

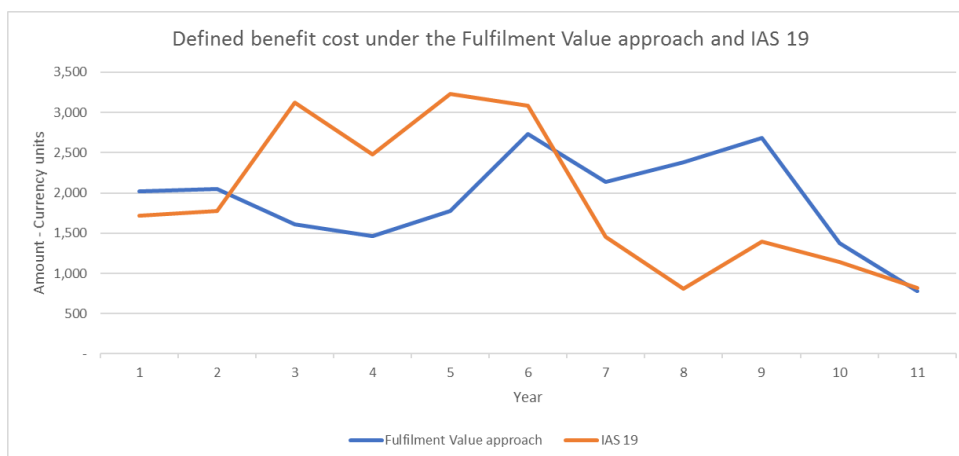
	Currency units	Currency units
Profit or loss:		
Current service cost		-1 939
Return on plan assets	454	
Financial expense:		
Interest expense	-459	
Changes in estimates	-184	
Remeasurement of the value of the minimum return guarantee	517	
Net financial expense		328
Total comprehensive income		-1 611

- 4.71 The return on plan assets is computed the same way as in IAS 19 and is the same amount. This represents the income from the assets each year using the actual asset rate of the year.
- 4.72 The interest expense for the pension obligation is the change in the pension obligation caused by the time value of money and changes in financial assumptions. This amount incorporates (i) accretion of interest based on the projected rate at the end of the prior year and (ii) the effect of changes in projected discount rates.
- 4.73 Changes in estimates relate to changes in current and/or future estimates of inflows and outflows of the pension obligation. In the example, there are changes in estimates resulting in a change to the final benefit entitlement which is payable just after Year Eleven. In the example, as a simplification, this does not include any changes to the value of the minimum return guarantee. These changes are incorporated in the remeasurement of the value of the minimum return guarantee.
- 4.74 In the example, the interest expense and changes in estimates are recognised in profit or loss. It would be relevant to consider whether they should be presented in profit or loss or should be split between profit or loss and OCI. Therefore, part (ii) of the interest expense mentioned in paragraph 4.72 above and changes in estimates in paragraph 4.73 could be presented in OCI. In the example, for Year Three, this amount is CU 274 and would be debited to OCI. When the pension obligation is settled, the accumulated amount presented in OCI is expected to be zero. Whether or not the amount should be recycled, would therefore not be an issue.

- 4.75 The value of the minimum return guarantee is recomputed at each reporting period based on the accumulated employer and employee contributions that have been made. The time value component of the minimum return guarantee is recognised as part of interest expense. The remeasurement of the value of the minimum return guarantee refers to past periods and represents any effect of changes in discount rates and changes to the intrinsic value of the minimum return guarantee.
- 4.76 The treatment of the value of the minimum return guarantee would be similar to the treatment of the pension obligation cash flows. In this example the remeasurement of the value of the minimum return guarantee is presented fully in profit or loss. However, similar to the interest expense and changes in estimates described above, the change caused by the time value could be recognised as part of interest expense in profit or loss and the other components relating to the remeasurement of the value of the minimum return guarantee in paragraph 4.73 could be presented in OCI. In this example, for Year Three, the remeasurement of the value of the minimum return guarantee amounts to CU 517 and is presented in OCI.
- 4.77 The graphs below show the actual net financial expense/(income) that would be recognised in profit or loss each year compared to the net interest expense under IAS 19.



- 4.78 Under the Fulfilment Value approach, the plan assets and the pension obligation (excluding the value of the minimum return guarantee) are the same amounts in the example up to Year Nine when the entity first projects the minimum return guarantee to become effective at retirement. The discount rate for both the plan assets and the pension obligation is also the same, therefore in the example, the net financial expense excluding the value of the minimum return guarantee until Year Nine is zero. This can be seen in the above graph under the legend Fulfilment Value approach - Net financial expense excluding the value of the minimum return guarantee.
- 4.79 The value of the minimum return guarantee decreases over time because of the systematic shortening of the coverage period. Therefore the remeasurement is increasingly negative in all periods. The trend is also affected by actual returns.
- 4.80 The chart below shows the defined benefit cost the pension plan for the Fulfilment Value approach compared to IAS 19:



4.81 In the chart above, apart from the increasing employer contributions over time (recognised as part of current service cost), the variability of the defined benefit cost under the Fulfilment Value approach is also due to changes in the value of the minimum return guarantee.

Comparing the Fair Value Based approach with the Fulfilment Value approach

4.82 In the table below, an overview of the similarities and differences between the Fair Value Based approach and the Fulfilment Value approach is presented. The comparison is based on the illustrative example, under which only financial assumptions vary. In a real-life example, the treatment of non-financial assumptions (periods of service, turnover rates and mortality rates) could be different under the two models.

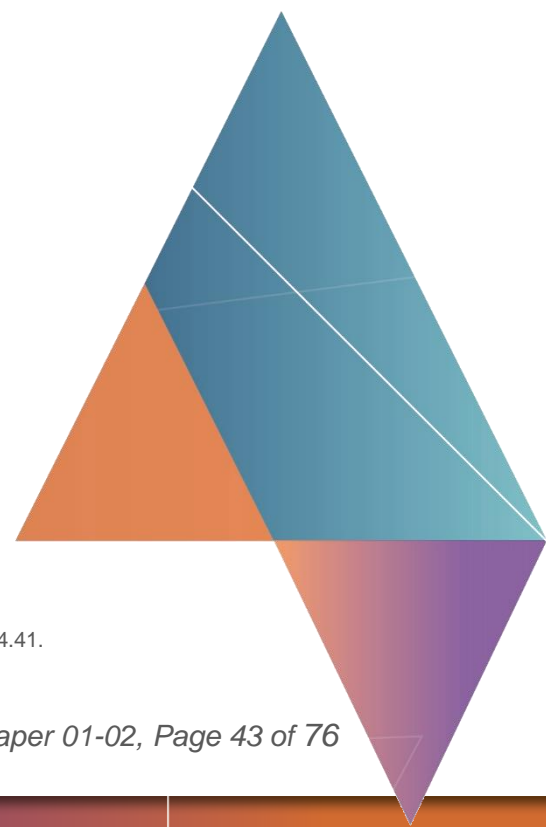
	Fair Value Based approach	Fulfilment Value approach
Measurement of plan assets	Fair value	Fair value
Measurement of pension obligation	The obligation is equal to (i) the value of the plan assets; and (ii) the fair value of the minimum return guarantee related to contributions paid until the reporting date.	The obligation is equal to the (i) the present value of the probability-weighted estimate of all future cash flows; and (ii) the fair value of the minimum return guarantee related to the contributions paid until the reporting date. The measurement reflects the perspective of the entity and does not take into account the entity's own credit risk.
Discount rate	The risk-free rate is an input to the fair value calculation.	The discount rate reflects the characteristics of the future cash flows and the asset-return promise.
Current service cost	The cost is equal to (i) the nominal amount of the employer's contribution for the period and (ii) the fair value of the minimum return guarantee	The cost is equal to: (i) the nominal amount of the employer's contribution for the period and (ii) the fair value of the minimum

	related to the contributions for the period.	return guarantee related to the contributions for the period.
Interest expense	N/A	The financial expense ¹⁰ consists of: interest expense which is equal to (i) the unwinding of the discount on the opening balance of the pension obligation based on the projected rate at the end of the prior year; and (ii) the effect of the change of the discount rate; and changes in estimates which relate to changes in current and/or future estimates of inflows and outflows.
Remeasurement of the value of the minimum return guarantee	The remeasurement of value of the minimum return guarantee related to past contribution is accounted for in profit or loss ¹¹ .	The remeasurement of the value of the minimum return guarantee is the effect of changes in discount rates and changes to the intrinsic value of the minimum return guarantee relating to past contributions. These are accounted for in profit or loss ¹² .

¹⁰ As an alternative, it could be required to recognise components (a) (ii) and (b) in OCI.

¹¹ As an alternative, it could be required to present the remeasurement in OCI. See paragraph 4.41.

¹² As an alternative, it could be required to present the remeasurement in OCI.



CHAPTER 5: ASSESSMENT OF THE APPROACHES

Introduction

- 5.1 The approaches discussed in Chapter 4 each have their advantages and disadvantages. This chapter describes these by listing differences in how the approaches meet aspects of the qualitative characteristics of useful financial information included in the IASB's Conceptual Framework for Financial Reporting.

Summarised assessment of the approaches

- 5.2 The assessments of the various approaches considered in this Discussion Paper are summarised in the table below. The table, and the following explanations, include only parameters that distinguish the approaches. This means that the table does not reflect general assessments on the extent the different approaches meet the qualitative characteristics. The assessment of the approaches is based on the scope defined in Chapter 2. The assessment could thus have been different, had a different scope been chosen.

Qualitative characteristics	IAS 19	Capped Asset Return approach	Fair Value Based approach	Fulfilment Value approach
Is the information relevant?				
• Does the approach reflect how the pension obligation will be settled?	★★☆	★★☆	★★☆	★★☆
• Is the economic covariance between plan assets and pension obligation reflected?	★★☆	★★☆	★★★	★★★
• Is a net pension liability recognised when the plan assets are expected to be insufficient to cover the portion of the final benefit entitlement for the service provided to date?	★★☆	★★☆	★★★	★★★
• Is current service cost useful for predictions about future profit margins?	★★☆	★★☆	★★★	★★★
• Is information about the value of the minimum return guarantee provided?	★★☆	★★☆	★★★	★★★
Is the employee's right to receive the higher of the return on plan assets and the minimum guaranteed return reflected in a complete manner?	★★☆	★★☆	★★★	★★★

Can requirements be applied retrospectively?	N/A	★★★	★★☆	★★☆
Is the obligation element related to the minimum guaranteed return accounted for similarly to plans under IAS 19?	N/A	★★★	★★☆	★★☆
Is the obligation related to the return on plan assets accounted for similarly to plans under IAS 19?	N/A	★★☆	★★★	★★★
Is the information understandable?	★★☆	★★☆	★★☆	★★☆
Will the implementation of the approach be uncostly?	N/A	★★★	★★☆	★★☆

Symbol	Explanation
★★☆	Low fulfilment of the qualitative characteristic.
★★★	Medium fulfilment of the qualitative characteristic.
★★★	High fulfilment of the qualitative characteristic.
N/A	The effect is not relevant to consider for the approach.

Is the information relevant?

- 5.3 One of the main characteristics of useful financial information is that it is relevant. Information should thus have the potential to make a difference when deciding to provide resources to an entity (e.g. by buying shares in the entity or providing a loan) and when assessing the stewardship of the entity's management.
- 5.4 When assessing whether to transfer resources to an entity, the expected return on and off such a transfer would often be considered. In addition, the related risk will be taken into account. That is, the expected cash flows and the uncertainty (the variance) related to these will be assessed. Relevant information is thus information that can make a difference in the assessment of the expected future cash flows and the variance related to these.
- 5.5 The various approaches differ on how they provide information for the assessment of expected future cash flows and the variance as follows:
- (a) The most useful information for making predictions about the expected future cash flows should reflect how a given pension obligation would be settled. None of the approaches would always reflect this. The approaches either provide an estimate of the resources needed to fulfil the obligation to the employee or to transfer the obligation to a third party. Similar to the approach included in IAS 19, the Capped Asset Return approach and the Fulfilment Value approach reflect an estimate of the resources needed to fulfil the obligation to the employee. In most cases this would reflect how the obligation will be settled. Accordingly, the Capped Asset Return approach and the Fulfilment Value approach would better reflect how a pension obligation is settled than a model based on the assumption that pension obligations are always transferred to third parties.

- (b) As explained below, IAS 19 and the Capped Asset Return approach would not always reflect the outflow assessed to be necessary to settle the obligation by transferring amounts to the employee. The reason is that in some cases the pension obligation will not be measured based on higher of the minimum guaranteed return and the actual return on pension assets. In some cases, the mechanics of the approaches will thus result in the measurement being based on the minimum guaranteed return although the minimum guaranteed return is expected to be lower than the actual return on plan assets. In other cases, the measurement could be based on the expected return on plan assets although this is lower than the minimum guaranteed return. Measurements under the Fulfilment Value approach would, on the other hand, always reflect situations under which the minimum guaranteed return is expected to be higher than the actual return on plan assets. The Fulfilment Value approach is therefore assessed to best reflect how the pension obligation will be settled.
- (c) A fair value approach would normally reflect the amount an entity would have to pay to transfer the obligation to a third party at the measurement date. As transferring a pension obligation to a third party generally seems to appear less frequently than settling the obligation with the employees when it is due, the Fair Value Based approach would often not reflect how the obligation will be settled. In addition, the measurement under the Fair Value Based approach presented in this Discussion Paper would only represent a rough estimation of the amount an entity would have to pay to settle the obligation if it would transfer it to a third party. The amount would seldom reflect what the entity would actually have to pay to transfer the liability.
- (d) If the variance in reported profit or loss over time should be an indicator of the variance of the expected net cash inflows, economic covariances that impact future cash flows should be reflected in the measurement of assets and liabilities (that will be reflected in profit or loss). For the pension plans considered in this Discussion Paper, the promised benefits depend on the return on plan assets if this is higher than the minimum guaranteed return. In these cases, the only cash outflows occur when the employer is making its contributions. Accordingly, fluctuations in profit or loss resulting from applying different measurement bases to the plan assets and the pension obligation would not reflect the economic covariance between the assets and the obligation. The covariance between plan assets and the pension obligation is best reflected under the Fair Value Based approach and the Fulfilment Value approach. Under the Fair Value Based approach both the assets and the obligation will be measured at the fair value of the plan assets. In addition, the measurement of the obligation will include the fair value of the minimum return guarantee. The covariance will be less visible under the Capped Asset Return approach. Under this approach, different measurement bases are used for the plan assets and the pension obligation. However, in cases in which an employee's service in later years will not lead to a materially higher level of benefit than in earlier years and the (uncapped) expected return rate is higher than the discount rate, the approach could appropriately reflect the covariances.
- (e) Users are particularly interested in assessing whether a pension plan is underfunded. A net liability should thus be recognised in the financial statements when the plan assets are expected to be insufficient to cover the portion of the final benefit entitlement for the service provided to date. As described above in paragraphs 2.17 - 2.18, IAS 19 would not always result in a net pension liability being recognised in such circumstances. The same could happen under the

Capped Asset Return approach. For example, if the discount rate is higher than the minimum guaranteed return rate, and this is higher than the expected actual return rate, the projections will be made based on the minimum guaranteed return rate and discounted using the higher discount rate. This would result in a potential short fall not being reflected when measuring the net pension liability. Both the Fair Value Based approach and the Fulfilment Value approach would, on the other hand, always result in the recognition of a net pension liability in such circumstances.

- (f) In order to make predictions about future profit margins and hence future cash flows, information about pension cost related to a particular period could be useful. The cost related to a particular period could be defined in different ways. Under the Fair Value Based approach and the Fulfilment Value approach, current service cost equals the contribution of the employer for the period and the value of the minimum return guarantee provided by the employer for both the contributions of the employer and the employee. If it is assumed that the increase in contributions reflects an increase in the value of the service provided by the employee, this information is helpful for predicting future margins. When an employee's service in later years will lead to a materially higher level of benefit than in earlier years, the backload correction should be applied under IAS 19 and the Capped Asset Return approach. IAS 19 and the Capped Asset Return approach will thus result in current service cost representing a proportion of the final benefit entitlement. This is also a measure of the cost related to a particular period. However, as exemplified above under (c), the measurement of the pension obligation, and hence the current service cost, may not reflect the actual outflow of resources expected. It could therefore be argued that this measure is less useful when making projections about future cash flows than the measure resulting when applying the Fair Value Based approach or the Fulfilment Value approach.

- 5.6 For the assessments of management's stewardship, information reflecting that employees are provided with a right to receive the higher of a fixed return and a variable return could be useful for the pension plans included in the scope of this Discussion Paper. This right has a value that should be taken into account when assessing the staff expenses of an entity and hence the costs the management of an entity has incurred when generating the income. Under both the Fair Value Based approach and the Fulfilment Value approach, the value of the minimum return guarantee is reflected. The Capped Asset Return approach would, on the other hand, not reflect the value of the right (i.e. the minimum return guarantee).

Is the information a faithful representation?

- 5.7 To be useful financial information must not only represent relevant phenomena. It must also faithfully represent the substance of the phenomena that it purports to represent. A perfectly faithful representation would have to be complete, neutral and free from error.
- 5.8 The approaches considered in this Discussion Paper differ on the completeness by which the employee's right to receive the higher of the return on plan assets and the minimum guaranteed return is reflected. IAS 19 and the Capped Asset Return approach would in most cases measure the pension obligation based on the higher of the minimum guaranteed return and the expected actual return on plan assets. However, the Fair Value Based approach and the Fulfilment Value approach would reflect the value of the right to receive the higher of the two returns. It is therefore assessed that the two latter approaches provide more complete information on the right to receive the higher of the return on plan assets and the minimum guaranteed return.

Can requirements be applied retrospectively?

- 5.9 Financial information is most useful when it can be compared between entities and with past financial information of the same entity.
- 5.10 If a new approach for accounting for types of pension plans is introduced, it 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.
- 5.11 The information needed for calculating the pension obligation in accordance with the Capped Asset Return approach, should in principle have been collected for the IAS 19 calculations. Generally it would therefore be possible to apply the approach retrospectively.
- 5.12 On the other hand, it may be difficult to apply the Fair Value Based approach retrospectively unless a sufficient time gap between the finalisation of new requirements and the effective date is introduced that would allow entities to collect the data used for presenting comparative figures under the new requirements while still reporting under the old requirements. Part of the information needed would be available from the calculation required under IAS 19, but some input may be more difficult to collect retrospectively.
- 5.13 Similarly, an entity may be able to apply the Fulfilment Value approach retrospectively, but it would depend on the extent to which the entity has information, e.g., relating to cash flows from prior years. The time gap between the finalisation of new requirements and the effective date of the requirements would also here impact entities' ability to apply the approach retrospectively.

Are similar elements of pension plans accounted for similarly to plans outside the proposed scope?

- 5.14 To assess the extent to which financial information resulting from the various approaches can be compared between entities, it is considered whether similar information will be accounted for similarly between plans within and outside the scope of this Discussion Paper. That is, it is assessed whether the approaches provide information that is comparable with the information resulting from applying IAS 19 to pension plans outside the scope of the project.
- 5.15 The plans considered in this Discussion Paper provide the employees with the higher of a minimum guaranteed return and the actual return on plan assets. It is the latter return that makes the plans special compared to "normal" defined benefit plans. If a plan would promise a very high minimum guaranteed return, so that the obligation would de facto be determined based on this minimum guaranteed return, the plan would be similar to a "normal" defined benefit plan. The extent to which an approach considered in this Discussion Paper would provide information that is comparable between entities would therefore depend on how similar the information provided under such a scenario would be to the information resulting from applying the requirements in IAS 19 for defined benefit plans.
- 5.16 When the obligation would de facto be determined based on the minimum guaranteed return, the Capped Asset Return approach would result in similar information as if the

requirements for defined benefit plans in IAS 19 had been applied. The Capped Asset Return approach thus results in information that would be comparable between entities. Conversely, the Fair Value Based approach would result in information that would be different from that resulting from applying IAS 19. Accordingly, the information resulting from the Fair Value Based approach would not be particularly comparable to the information provided by entities that would not be covered by the scope of this Discussion Paper and hence account for the plan in accordance with IAS 19. The same would apply for the Fulfilment Value approach. Some differences between the Fulfilment Value approach and IAS 19 are presented below.

IAS 19	Fulfilment Value approach
Discount rate applying High Quality Corporate Bond rate.	Discount rate reflects current markets and the extent to which there is dependence on the asset returns.
Attributions of benefits on a straight-line basis when an employee's service in later years will lead to a materially higher level of benefit than in earlier years.	Attributions of benefit reflect the contributions of the employer and a value of the minimum return guarantee for each period.
No risk adjustment.	Risk adjustment included in measurement.

- 5.17 It could be argued that the pension plans considered in this Discussion Paper are very similar to a defined contribution plan when the minimum guaranteed return is very low and the pension obligation accordingly would be determined based on the expected return on plan assets. For the part of the pension obligation related to the return on plan assets, it could be argued that when the entity has made its contribution, it will have no legal or constructive obligation to pay further contributions as the fund cannot be in a position under which it would not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods. The Fair Value Based approach and the Fulfilment Value approach would result in an outcome similar to the requirements for defined contribution plans in IAS 19. The Capped Asset Return approach would not.

Is the information understandable?

- 5.18 Information which is unnecessarily complex is less useful than less complex information.
- 5.19 When assessing how easy the information resulting from the various approaches is to understand, it has been examined how easy it is to explain what the resulting figures would represent.
- 5.20 It does not seem to be particularly easy to explain what the resulting figures from the Capped Asset Return approach represent. It would be difficult to explain what the figures represent without explaining how they are calculated. When a backload correction is included in the computations, the obligation can be explained as the total expected return, capped at the discount rate, on all contributions that on a straight-line basis can be attributed to the current and past years, discounted by the interest on high quality corporate bonds. However, in cases in which an employee's service in later years will not lead to a materially higher level of benefit than in earlier years and the (uncapped) expected return rate is higher than the discount rate the figures resulting from the approach could relatively easily be reconciled with the contributions to the pension scheme. In such situations, the figures would thus be easier to explain than those resulting from applying the requirements in IAS 19 for defined benefit plans.

- 5.21 On a high level, it could be relatively easy to explain that the pension obligation resulting from applying the Fulfilment Value approach would represent an estimate of the outflows needed to fulfil the obligation related to the pension for the work performed to date. The service cost would also be easy to explain as the contribution of the period plus the value of the promise that the employee will receive the higher of a guaranteed return and the actual return on plan assets. It could thus be easier to provide a broad description of the figures resulting from applying the Fulfilment Value approach than the Capped Asset Return approach. However, it would not be easy to explain the detailed calculations of the amounts. This is partly because the amounts reflect expectations about the future salary and various assumptions, for example, assumptions relating to the pension obligation discount rate.
- 5.22 The pension obligation resulting from applying the Fair Value Based approach would probably also be easier to explain than the obligation resulting from the Capped Asset Return approach. The figure cannot be explained as the amount the entity would have to pay in order to transfer the obligation to a third party. This is because of the simplifications used when calculating the amount. However, the amount could be explained as the (estimated) fair value of the plan assets plus the (estimated) fair value of the minimum return guarantee for contributions made to date. The service cost could similarly be explained as the contributions made in the period plus the value of the promise to provide the minimum return guarantee on contributions made by the employer and the employee in the period.

Will the implementation be uncostly?

- 5.23 Financial information can be costly to prepare. Therefore the cost of providing the information should also be taken into account before requiring particular information.
- 5.24 The three suggested approaches may all be as costly or costlier to apply than the requirements in IAS 19 for defined benefit obligations.
- 5.25 There will be cost associated with implementing any of the three suggested approaches. However, as the Capped Asset Return approach would be quite similar to the current IAS 19 requirements, it could be expected that this approach will be significantly less costly to implement than the Fair Value Based approach and the Fulfilment Value approach.

CHAPTER 6: DISCLOSURE REQUIREMENTS

- 6.1 IAS 19 prescribes extensive disclosure in relation to defined benefit plans. The information entities are required to provide includes:
- (a) The nature of the benefits provided;
 - (b) A description of the risks to which the plan exposes the entity;
 - (c) A reconciliation of the movements in the period for the net defined liability/asset;
 - (d) A disaggregation of the fair value of the plan assets;
 - (e) The significant actuarial assumptions used to determine the defined benefit obligation;
 - (f) A sensitivity analysis for each significant actuarial assumption;
 - (g) A description of any asset-liability management strategies;
 - (h) Information about the maturity profile of the defined benefit obligation.
- 6.2 Plans with an asset-return promise as defined in this Discussion Paper are specific in relation to the nature of the benefits provided, which include both a minimum guaranteed return and a promise based on the return on the underlying assets. EFRAG considers that a description of these characteristics would be covered by the disclosure requirement in paragraph 6.1(a) above.
- 6.3 The entity is exposed to risk of having to make additional contributions to the extent that the minimum guaranteed return exceeds the cumulative actual and expected returns. EFRAG considers that disclosure of the relationship between the two and the likelihood of additional contributions would be covered by the disclosure requirement mentioned in paragraph 6.1(b) above.
- 6.4 In addition to the disclosures required by IAS 19, EFRAG considers that it would be useful to disclose the approach applied in determining the expected return on the plan assets, and, if a reasonable change in that assumption would lead to an increase in future contributions, what the effect would be on the contribution in the next annual reporting period.
- 6.5 In its current Disclosure Initiative project, the IASB has selected IAS 19 as one of the IFRSs for its Standard-level review of existing disclosures. At this stage, EFRAG considers that, regardless of the measurement of the defined benefit obligation, the disclosure requirements in IAS 19 are appropriate for plans with an asset-return promise.
- 6.6 Some additional disclosure could be needed under the approaches explored in this Discussion Paper. In the Capped Asset Return approach, EFRAG considers that, if the entity is capping the projection rate at the discount rate, the fact should be disclosed and the entity should indicate that the final benefit entitlement is higher than the undiscounted defined benefit obligation. However, there should not be a requirement to determine this higher amount.

- 6.7 In the Fair Value Based approach, EFRAG considers that the entity should comply with the applicable disclosure requirements in IFRS 13 *Fair Value Measurement*, subject to the appropriate aggregation and consideration of materiality. IFRS 13 requires entities to disclose information about the valuation techniques and inputs used to develop the measurement.
- 6.8 The Fulfilment Value may need additional disclosures once the approach is articulated in the details. For instance, if the approach would require or allow the entity to split the interest rate changes between profit or loss and OCI and to require or allow changes in estimates to be recognised in OCI (see discussion in paragraph 4.74 above) the entity would be required to indicate the fact and explain the basis for the split. Similarly, the entity should disclose estimation methodologies and input used for the calculation of the value of the minimum return guarantee and discount rates used.



CHAPTER 7: OTHER POSSIBLE APPROACHES AND THEIR IMPLICATIONS

Introduction

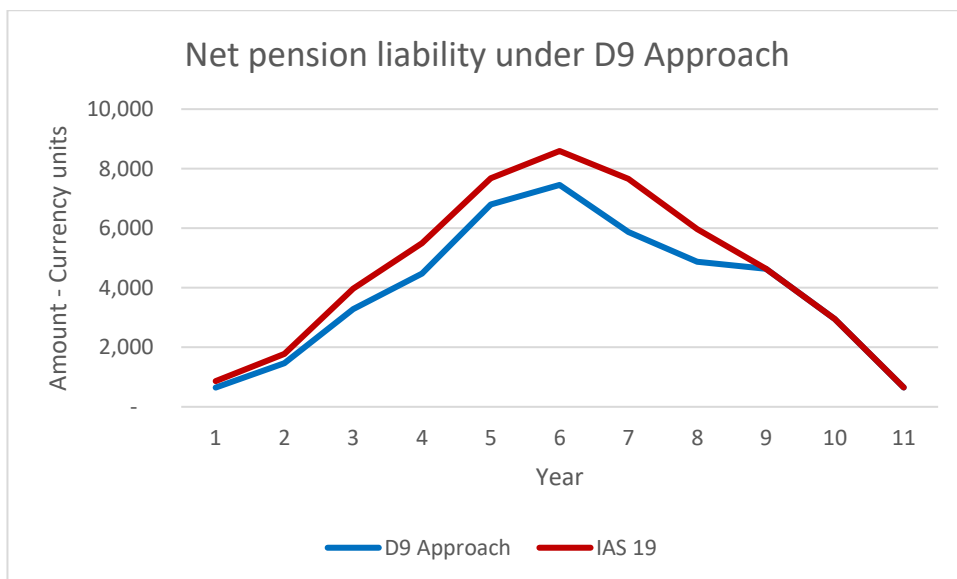
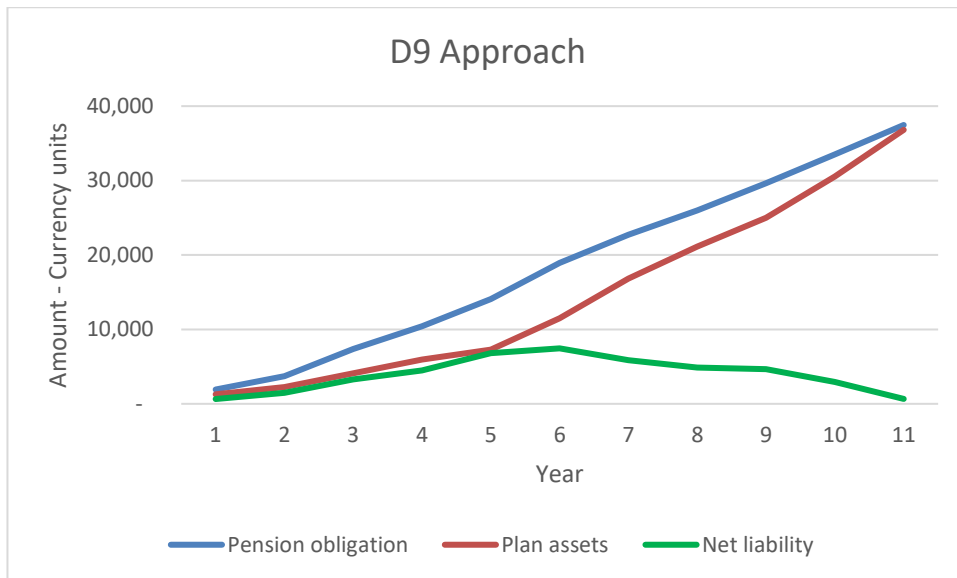
- 7.1 In this chapter, other possible approaches to address the reporting for plans with an asset-return promise are briefly described.

D9 Employee Benefits Plans with a Promised Return on Contributions or Notional Contributions

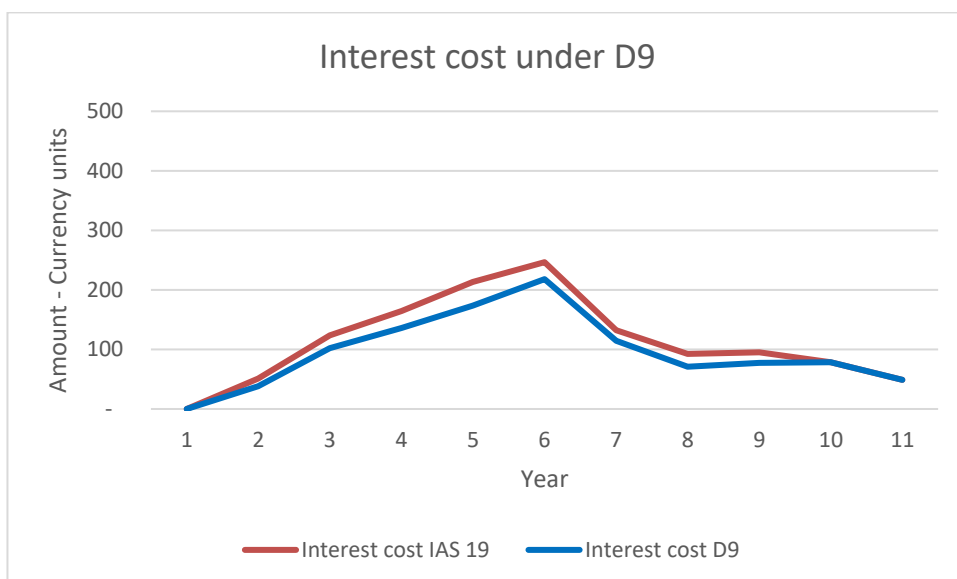
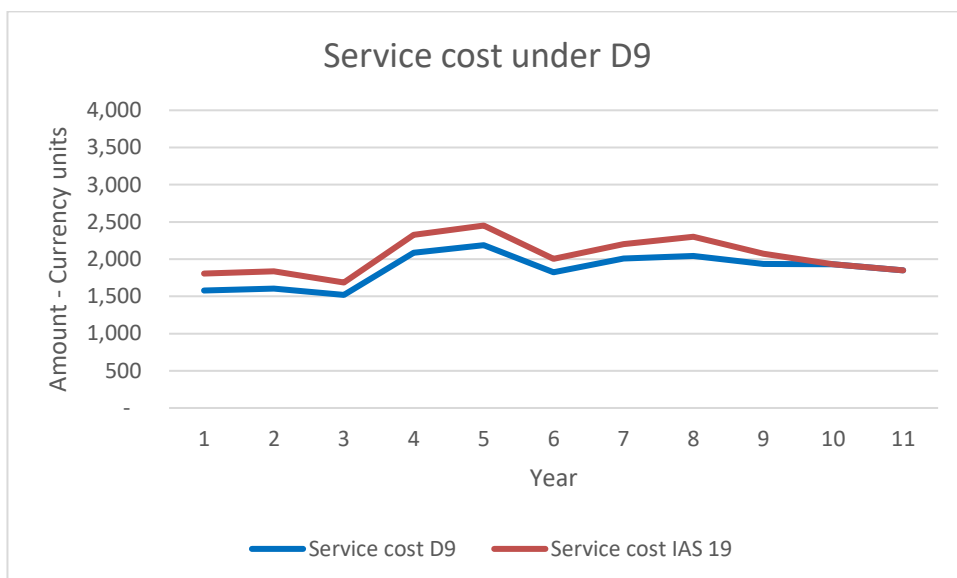
- 7.2 In the past, the IFRS Interpretations Committee ('IFRS IC') explored an approach under which the sponsoring entity would first determine the liability for the guaranteed promise using the IAS 19 requirements. The entity would then compare this amount to the fair value of the plan assets upon which the benefits were dependent; if the latter amount would be higher, the entity would accrue an additional liability equal to the difference between the two.
- 7.3 IFRS IC published in 2004 the Draft Interpretation D9 *Employee Benefits Plans with a Promised Return on Contributions or Notional Contributions*. The IFRS IC noted that projecting the benefits at the higher of the expected return and minimum guaranteed return rate was not appropriate, because the discount rate in IAS 19 does not reflect the expected return. For this reason, the IFRS IC concluded that the projection of the benefits should be based on the minimum guaranteed rate, and the asset-return promise should be measured on a stand-alone basis. The Basis for Conclusion stated that the proposed approach acknowledged the nature of these type of plans as defined benefit plans, but reduced the complexity.
- 7.4 Draft Interpretation D9 also specified that if the benefits were subject to vesting conditions (such as completing a minimum period of service), the probability of forfeiture would be incorporated in the measurement of the asset-return promise. Also, the adjustment due to the recognition of the additional liability for the asset-return promise would be treated as a separate pension cost – with no specific indication of whether this would be presented in profit or loss or OCI.
- 7.5 Reactions to Draft Interpretation D9 were mixed. Some respondents noted that the split of the liability into the components failed to capture the time value of the option.
- 7.6 The IFRS IC eventually decided not to finalise the Interpretation. This was due mainly to a scoping issue. The IFRS IC concluded that it could not find a consensus on a suitable scope that would at the same time improve the accounting for a sufficiently large population of plans and avoid arbitrary distinction between economically similar plans.
- 7.7 The D9 approach removes the need to project future returns on the plan assets, therefore eliminating the counterintuitive effect that, when the projection increases, the liability also increases although there is no additional contribution to be paid. Paragraph 148 of the Basis for Conclusion in IAS 19 notes that, in the IASB's view, projecting the benefit on the basis of current assumptions of future investment performance is consistent with estimating the ultimate cost of the benefit, which is the objective of the measurement of the defined benefit obligation. However, the assessment of the future returns is judgmental and paragraph 78 of the Basis for Conclusion acknowledges that it could not be determined in an objective way.

7.8 If the plan holds the assets upon which the benefits are dependent, the entity will already have to measure these at fair value for the purpose of the financial statements. If the assets are not held, the D9 approach will require the entity obtaining the fair value of the notional portfolio.

7.9 The graphs below show the different elements of the net pension liability recognised in the statement of financial position when applying the D9 approach for the case example. The graphs also compare the net pension liability under the D9 approach with that resulting from applying IAS 19.



7.10 The graphs below compare the service cost and interest cost under IAS 19 and D9. In the specific example there is no recognition of an additional obligation for the asset-return promise. In other circumstances, the comparison would look differently.



7.11 If the D9 approach was applied to the illustrative example and compared to the outcome of IAS 19, these would be the main differences:

- (a) The net pension liability under the D9 approach would be lower than under IAS 19 in the first years, because the pension obligation would be based only on the amount of the total guaranteed benefit. No additional obligation would be recognised for the asset-return promise, because in the first years the fair value of the asset is lower than the pension obligation;
- (b) In the case, assumptions change every year. If this would not be the case, the assumptions made in Year 1 would apply throughout the eleven years. If this was the case, the start recognising an additional obligation for the asset-return promise in Year Ten, when the fair value of the plan assets would exceed the pension obligation based on the total guaranteed benefit. The entity would therefore have a net pension liability of nil starting from Year Ten;
- (c) The pension obligation (and the net liability) under the D9 approach and IAS 19 would be the same at the end of Year Nine. This is because in the illustrative

example at the end of Year Nine the final entitlement benefit is now based on the minimum guaranteed return. Both approaches would then measure the pension obligation based on the final entitlement benefit. The recognition of an additional obligation that in Year One was forecasted to happen in Year Ten would then not occur;

- (d) In Year One, the cumulative pension cost projected over the total period would be the same under the two approaches; the presentation would be different, due to the separate presentation of the adjustment for the asset-return promise under D9;
- (e) At the end of Year Eleven, the cumulative service cost and interest cost under D9 approach would be lower than under IAS 19. Under the D9 approach, the service cost is calculated based on the guaranteed amount (which in the first years is lower than the expected total entitlement) and the interest cost is determined on a lower liability;
- (f) As a consequence, at the end of Year Eleven the credit balance in OCI would be lower under D9. The reduction of the discount rate, that in later years creates the need to increase the amount of the liability, generates a bigger actuarial difference under D9. This adjustment debits OCI and credits the liability.

7.12 In some other circumstances the cost recognition pattern under the D9 approach may increase significantly in later years. This would be the case when the final entitlement is based on the asset-return promise (i.e., the fair value of the plan assets at retirement exceeds the total guaranteed amount) and excess of the fair value of the plan assets over the guaranteed amount is generated in the later years.

Component approaches

7.13 In substance, the D9 approach splits the obligation into two components – the asset-return promise and the guarantee, and measures them independently. The obligation is then measured based on the higher of these. There are other approaches to split the plans considered by this Discussion Paper into components. The following paragraphs discuss some of these.

A defined contribution component and a guarantee component

7.14 A plan within the scope of this Discussion Paper could be split into a defined contribution component and a guarantee component. The asset-return promise could be argued to be a component for which the entity's only obligation is to pay its contribution. The risk related to the variability on the returns is borne by the beneficiary. This component could accordingly be seen as a defined contribution plan and treated correspondingly. The entity is potentially exposed to additional contributions only for the guarantee - this could be separately accounted for using its intrinsic value, its fair value or another estimate of the potential outflows.

7.15 This analysis applies to those plans for which the only source of uncertainty is the variability of future returns; in other words, there are no biometric risks. The separation would be more complex if the variability of the benefit at retirement depended on factors such as employee turnover or longevity.

7.16 There would still be aspects that would need to be elaborated. The entity could be required to measure only the guarantee related to amounts of contributions already paid;

alternatively it could be required to apportion the total expected cost of the guarantee over the period of service using a straight-line method.

- 7.17 EFRAG has not considered how the guarantee should be measured. Option pricing models would normally be used to determine fair values, but they may be complex to apply to guarantees that are affected also by non-financial factors.
- 7.18 An intrinsic value approach would result in the entity not recognising any amount on its statement of financial position when the guarantee is out of the money at the reporting date (assuming the plan is funded). This may lead to not appreciating the risk exposure of the entity to future changes in the investment returns, and would require, at a minimum, robust disclosure in the notes of the characteristics of the guarantee:
- (a) Whether it provides a fixed or a minimum return;
 - (b) The level, and whether it is set on nominal or real terms;
 - (c) The period over which it applies (cumulative or period-by-period); and
 - (d) The extent to which it may be reset during the application period.

Split based on risk types

- 7.19 The different types of risks in a pension plan could be another basis to split plans within the scope of this Discussion Paper into components. Some components would reflect a financial risk only and some would reflect biometrical risks. The components could then be accounted for based on the guidance for similar instruments. The pension plan explained in Chapter 3 and used to illustrate the effects of the various approaches in Chapter 4 could thus be considered to consist of:
- (a) A promise to provide a fixed return on an amount;
 - (b) A promise to provide the return of and on assets in which contributions are invested.
- 7.20 The first promise would for each of the contribution have a risk profile similar to an issued zero-coupon bond. This component would accordingly be a financial instrument and it could be considered to measure this at amortised cost or at fair value.
- 7.21 The second promise would also be a financial liability. According to the existing guidance for financial instruments, this instrument should be measured at fair value.
- 7.22 The example considered does not include any biometrical risk (or insurance risk). However, such risk could be present in the types of pension plans considered. If, for example, the entity would not have to pay any amount if the beneficiary would be dead before reaching the retirement age. Insurance risk could be accounted for in accordance with the guidance on insurance contracts.
- 7.23 The two components identified above in paragraph 7.19 cannot initially be measured completely independently. That is, the zero-coupon bond cannot, for example, initially be measured at amortised cost or fair value based on the contributions made and the promised minimum return. Such an approach would result in recognising a full liability for both the variable return promise and the minimum guaranteed return promise. Whereas the plan would only require one of the promises to be fulfilled at retirement.

- 7.24 Therefore, the fair value of the promise related to each contribution is split between the two components mentioned in paragraph 7.19 above based on the relative fair values of these promises at the time of the contribution. Accordingly, if the fair value of the promise at the time of the contribution would be CU 100 and the fair value of the guaranteed return promise would be 20% of the fair value of the total promise (i.e. the guaranteed return promise and the variable return promise), CU 20 would be allocated to the guaranteed return and CU 80 to the variable return promise. The subsequent measurement of the promises would then be based on these amounts.
- 7.25 The approach would result in the components of a pension plan being accounted for in accordance with existing requirements for similar types of risks. The measurement of the identified component may also be less complex than, for example, the Fair Value Based approach considered in Chapter 4 above, if the split between the various identified components is not subsequently updated. However, when the split is not updated, the measurement of the liability just before it is settled would not correspond to the amount required to settle the liability. The approach could also result in underfunding not being appropriately reflected and the service cost recognised would generally not correspond to the outflow of resources related to providing the pension plan.

Other types of component approaches

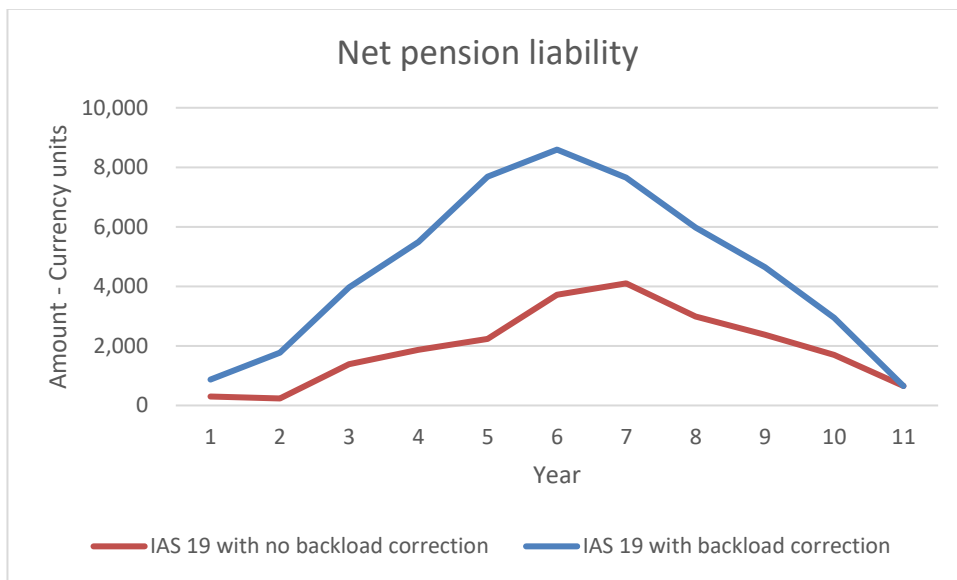
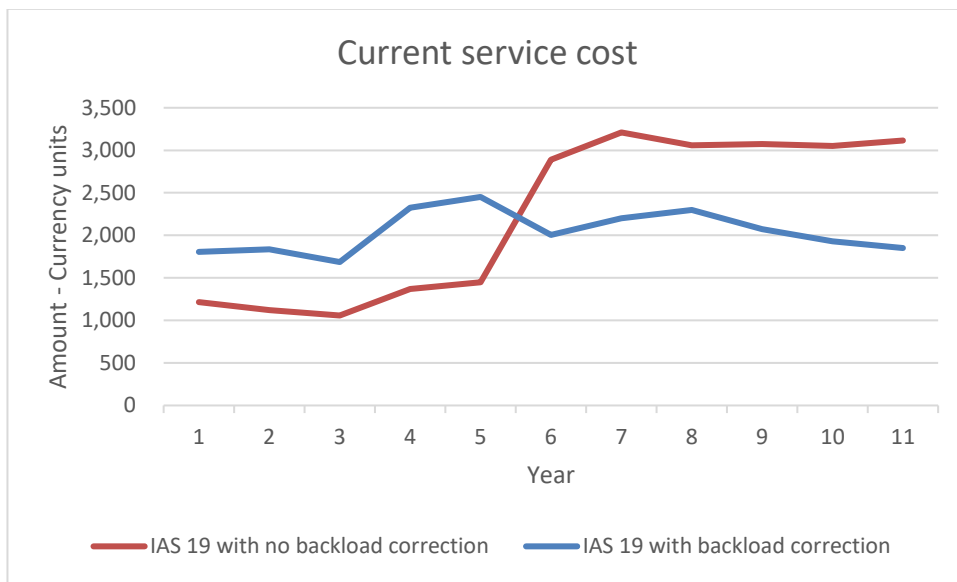
- 7.26 Other types of component approaches that could be considered, include:
- (a) An IAS 19 approach under which the pension plans in the scope of this Discussion Paper are split into a defined benefit component and a defined contribution part. That is a pension plan is split into the following two components:
 - i) A defined benefit component, and
 - ii) A defined contribution component.
 - (b) The difference between this model and the D9 model described above is that under the D9 model, the measurement of the total pension obligation would be based on the component with the highest value. Under the alternative approach, the total pension obligation would be split into two components – for example, by following the approach described above in paragraph 7.24 above. These components would be measured separately following the guidance in IAS 19 for defined benefit plans and defined contribution plans and the total pension liability would be made up of the sum of the two components.
 - (c) A combined IAS 19 and IFRS 9 approach under which a plan in the scope of this Discussion Paper is either considered to be:
 - i) A defined contribution plan plus a fixed return option (which would be accounted for as a derivative); or
 - ii) A defined benefit plan (based on the fixed return) plus an option (a financial derivative) to convert a fixed return into a variable return.
- 7.27 The variant of the combined IAS 19 and IFRS 9 approach under which the plan is accounted for as a defined contribution plan plus a fixed return option, would be similar to the approach described above in paragraphs 7.14 to 7.18. However, under the combined IAS 19 and IFRS 9 approach, it would be given that the guarantee would be measured in accordance with IFRS 9. In addition, the approach would on many aspects resemble the Fair Value Based approach described in Chapter 4.

- 7.28 The variant under which the plan is accounted for as a defined benefit plan plus an option to convert a fixed return into a variable return, would only make use of the requirement in IAS 19 on how to measure the pension obligation. This means that it would not involve use of the asset ceiling when calculating the net liability. However, the approach would still result in similar issues as when applying the requirements in IAS 19 for defined benefit plans on plans within the scope of this Discussion Paper.

IAS 19 approach with no backload correction

- 7.29 As mentioned above, IAS 19 requires that if an employee's service in later years will lead to a materially higher level of benefit than in earlier years, an entity shall attribute benefit on a straight-line basis. The backload correction applies in the circumstances of the illustrative example, due to the increase in the percentage of contribution.
- 7.30 In Section 8 below (paragraph 8.28 and following) the Discussion Paper illustrates the general debate on the backload correction. The question addressed here is whether there is an argument to exempt the use of the backload correction for the plans that are within the scope of this Discussion Paper.
- 7.31 The backload correction results in an apportionment of the pension obligation and service cost that is independent of the pattern of the payment of contributions. It could be argued that this is appropriate when the final entitlement is independent from the pattern of payment of contributions (for instance, a plan that pays a fixed amount for each year of service), but not in other cases. For the plan in the illustrative example, the asset-return promise is computed from the moment of payment of each contribution, so if the payment pattern was different, then the final entitlement benefit would also change. This could provide an argument to avoid the application of the backload correction.
- 7.32 However, it should be noted that plans other than those in scope of the Discussion Paper share the same characteristic. For instance, in a plan that only guarantees a fixed return the final entitlement also is dependent on the timing of payment of contributions. The same would apply to a plan with an asset-return promise where the plan assets are not held.
- 7.33 If the backload correction was not applied, the entity would measure the pension obligation at each reporting date as the sum of (i) the contributions paid to date; (ii) the actual returns until the reporting period; and (iii) the expected returns on (i) plus (ii) until the end of the service period, discounted back using the high quality corporate bond rate. The pension obligation could, however, not be lower than the contributions paid to date plus the minimum guaranteed return until the end of the service period discounted back using the high quality corporate bond rate.

7.34 If this approach was applied to the illustrative example the current service cost and the net pension liability would develop as illustrated in the graphs below.



7.35 Not applying the backload correction thus reduces the net pension liability compared with the IAS 19 approach with the backload correction. It does, however, not fully eliminate the concerns previously raised, i.e. the use of a different rate in projecting and discounting the final entitlement benefits (that does not reflect the alleged economic linkage between the plan assets and the benefits to be paid) and the recognition of a net pension liability even when the payment of further contributions for past periods is unlikely. For further explanation, refer to paragraph 2.14 to 2.16.

CHAPTER 8: ISSUES NOT ADDRESSED BY THIS PAPER

Introduction

- 8.1 EFRAG acknowledges that concerns have been raised in relation to some of the requirements in IAS 19, that are not addressed in this Discussion Paper. For completeness and clarity, it is appropriate to mention these concerns.

The binary nature of IAS 19

- 8.2 IAS 19 classifies all pension plans using a binary distinction – defined contribution and defined benefit plans. Classification of traditional plans with relatively simple features into the two categories was properly depicting the essential differences. However, the classification may not appropriately reflect the characteristics of some newer types of plans.
- 8.3 The definition in IAS 19 does not require to consider whether the sponsoring entity's risks of having to pay further contributions if a fund does not hold sufficient assets to pay all employee benefits are substantial. However, the general materiality requirements apply. When the above risks are insignificant, some would argue that the plans are economically similar to defined contribution plans under which the entity's obligation is limited to the contributions. The definitions of defined benefit plans and defined contribution plans in IAS 19 do not further elaborate on the nature of the risk exposure.

The rise of risk-sharing features

- 8.4 In the last decades traditional defined benefit plans have come under pressure due to a combination of increased longevity of plan participants, reduction in active workforce and decreasing (or even negative, like during the financial crisis) investment yields. At the same time, national governments have tried to increase participation in the second and third pension pillars to avoid excessive pressure on public pensions.
- 8.5 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'.
- 8.6 'Hybrid plans' is not a term used in IFRS Standards - as explained above, defined benefit plans are a 'residual' category. If the IASB was to develop an alternative model for these 'hybrids' it should start by either defining them or introducing a positive definition of defined benefit plans (in that case, hybrid plans would become the residual category).
- 8.7 Some studies refer to 'pure defined benefit plans' when the following features are present:
- (a) The benefit is determined solely on the basis of the final salary or average career salary (instead of current salaries in each year of service); and
 - (b) The benefit is or could be paid as a pension annuity.
- 8.8 These plans are therefore exposed to all the following risks:
- (a) The pre-retirement investment risk;

- (b) The salary inflation risk; and
 - (c) The post-retirement longevity risk.
- 8.9 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 the 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.
- 8.10 The terms of the plan may differ, but in substance there is a built-in adjusting mechanism that, based on funding situation of the plan, would result in different scenarios:
- (a) An increase in the sponsors contribution, but capped to a certain amount so the entity is not exposed to unlimited additional outflows;
 - (b) An increase in the participants' contribution;
 - (c) A reduction or deferral of some or all the benefits in the plan.
- 8.11 Conversely, a situation where the plan is overfunded may result in additional benefits, such as an indexation of the benefits. Changes in the status over the life of the plan may also result in reversals of prior adjustments.
- 8.12 Cash balance plans are another type of plan commonly referred to as a 'hybrid' plan. 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.

What has the IASB done on the issues?

- 8.13 During the 2011 revision of IAS 19, in February 2011 the IASB discussed plans with risk-sharing features. The IASB decided not to amend the distinguishing criteria in IAS 19, but to clarify that the existence of a benefit formula does not in itself make a plan qualify as a defined benefit plan, unless the formula gives rise to an obligation to pay additional contributions.
- 8.14 Therefore, if the payment of the benefits specified in the formula are subject to the plan having sufficient assets (and in the absence of that, there is no obligation for the sponsor to contribute additional amount), then the plan is a defined contribution plan.
- 8.15 The amendments also addressed plans subject to conditional indexation, the effect of limits on the sponsor's additional contributions and contributions from employees and third parties.
- 8.16 IAS 19 paragraph 88(c) requires reflecting possible benefits changes that are set out in the formal terms of the plan. During the development of the paragraph there was debate about the inclusion of conditional indexation in the projection of the benefits. Some constituents argued against it, because the plan assets do not reflect the conditional indexation until the returns are incorporated in their fair value.

- 8.17 IAS 19 paragraph 91 deals with those plans that meet the definition of a defined benefit plan but where the terms limit the contribution that the entity is required to make. In this case, the cost of the benefit takes account of the limit on the contribution.

Some possible directions to explore

- 8.18 Plans with risk-sharing features raise different issues. EFRAG has had some tentative discussion on possible directions to explore, but has not developed these ideas further.
- 8.19 IAS 19 requires defined benefit accounting even when the sponsor is unlikely to pay anything more than the recurring contributions. Even if the minimum guaranteed return has been historically well below the expected return of the plan assets, and this is not expected to change in future, the entity still needs to perform the defined benefit calculation. The degree of uncertainty of future cash outflows is incorporated in the measurement of the defined benefit obligation and is not relevant for the classification of the plan.
- 8.20 When the expected return significantly exceeds the minimum guaranteed return, the economic value of the minimum return guarantee may be negligible; it may therefore be argued that the investment risk is not substantial, which under paragraph 30 of IAS 19 is the defining feature of defined benefit plan.
- 8.21 IAS 19 still requires the use of defined benefit accounting and a material pension obligation may still arise due to the use of the backload correction and the difference between the projection rate and the discount rate.
- 8.22 The question arises whether defined contribution accounting should also apply to those plans where the possibility that entity needs to pay further contributions in relation to the current and past services is remote. This would reduce significantly the cost and complexity for entities.
- 8.23 However, this approach would require investigating the following aspects:
- (a) The selection of the threshold. A quantitative threshold would be difficult to determine objectively and assess on an ex-ante basis; qualitative thresholds may be applied differently;
 - (b) A potential cliff effect. The degree of risk changes over time, and a plan risk exposure may move above (or below) the defined threshold. Moving from defined contribution to defined benefit accounting would involve significant complexity;
 - (c) The accounting for plan assets. If the plan is an excess position and the entity has a claim to the excess, defined contribution accounting would result in omitting information about the net asset of the entity in the plan.
- 8.24 It should also be assessed if this approach would be consistent with recent developments in IFRS. In the Conceptual Framework for Financial Reporting, the IASB has removed the assessment of the probability of future cash flows from the definition of assets and liabilities. The likelihood of future cash flows would now affect the measurement (or, when the variability is significant, it could affect the recognition).
- 8.25 As mentioned above, in some cases the plan terms put a cap to the additional contributions that the entity may be required to pay in relation to current and past services. It could be argued that this plan is economically similar to a defined contribution plan - in both cases, the entity's exposure cannot exceed a specified amount.

- 8.26 Again, would defined contribution accounting be suitable for this type of plan? In principle, it would be possible to apply the requirements in paragraph 51 of IAS 19 to measure the pension obligation as the difference between the contribution payable to date and the contributions already paid - although a present value calculation would also require an estimation of the timing of the potential additional payments.
- 8.27 However, this approach may result in overstating the liability. This is because the contribution payable is the maximum exposure, but the actual outflows could be lower, or even nil. To avoid a risk of a final reversal of cost upon winding up the plan, the entity would need to project the expected contributions - but then it would reintroduce complexity in the calculation.

The backload correction and its scope of application

- 8.28 For plans that qualify as defined benefit plans, IAS 19 requires the application of the projected unit credit method. If the employee's service in later years lead to material increases in the benefits, the entity is required to allocate the benefit on 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).

What view does it reflect?

- 8.29 This reflects the view that a post-retirement benefit is a stipulation that covers the full period of service. Historically, pensions were viewed as a gratuity act from the employer - therefore, the pension cost was linked to the cash outflow as the employer was not seen to have any obligation. The cost was then measured either by the pension benefit paid; or by the contribution paid in a funded scheme. The cost could also include the guaranteed return, if the contributions were not segregated to buy securities.
- 8.30 The gratuity theory was then challenged by the view that a pension is a deferred payment and that employees accept lower wages in exchange for future pension benefits. This led to the conclusion that an entity should account for the cost to provide the future benefits. The accounting change was also brought by governments granting tax deduction for pension costs. Cost was measured based on actuarial calculations (when the firm was using internal funding) or contributions to external funds, also determined based on actuarial calculations. In this last case, the cost would still correspond to the cash outflow of the period.
- 8.31 The accounting theory further developed by introducing the notion that pension benefits are an exchange. However, while the employer's promise was identifiable - the future payment of the benefits - the employee's side was less clear. It was suggested that the employee accepts to provide services in exchange of the future pension promise; since it is not possible to allocate benefits to specific unit of services, the objective of accounting should be to spread the value of the benefits to the full period of service.
- 8.32 This line of thinking viewed pensions as an integral part of an 'implicit lifetime contract' between employees and firms, and led to the notion of the projected unit credit method - that is, the cost should reflect the increase in the current expectation of future benefits, rather than only the increase in the current rights at the reporting date.

What are the arguments for and against the backload correction?

- 8.33 To understand one of the arguments for the backload correction, it has to be taken into consideration that the application of the projected unit credit method in IAS 19 requires

the effect of future salary increases to be reflected in the measurement of liabilities and of expenses that are recognised as services are provided. Some have argued that future salary increases should not be reflected in the liability.

- 8.34 The argument for including the effect of expected future salary increases is that if no increase is assumed, this is an implicit assumption that no change will occur and it would be misleading to assume no change if an entity expects a change. There is a difference between making a promise to provide a pension contribution based on the current salary and a promise to provide a pension contribution also based on the future salary. The latter promise would have a higher value for the employee, which should be reflected.
- 8.35 The argument against included the effect of expected future salary increases is that only benefits that the entity is presently committed (by legal or constructive obligation) to pay should be reported as liabilities. Benefits which the entity might become committed to in the future are not present liabilities. Employees typically become more expensive as they progress through their careers. In addition to paying higher current benefits as they progress, the employer may also make the original pension promise more valuable with each increase in pensionable salary. Accounting for the salary increase in the periods in which it occur but taking the increases of the pension payments into account when an employee joins a pension scheme is inconsistent. It can also be questioned whether a promise to increase pension payments when salary increases has an additional value (as argued above) as employers often have considerable discretion over the components of a competitive remuneration package. There are many examples where managements have taken actions to change reward structures for future service to address the pension cost element, such as replacing pensionable salary increases with non-pensionable bonuses.
- 8.36 There is also an argument that whether or not future salary increases should be considered would depend on the unit of account. That is, there is a different answer to the question whether the obligation should reflect future salary increases if the issue is approach by focusing on the employer's obligation to the workforce as a whole rather than to an individual employee. Even if it could be concluded that the employer does not have an obligation to increase pensionable salaries of any individual employee, that argument is much less plausible if the focus is on the workforce as a whole.
- 8.37 Finally, there is also an argument that while an inflation element of salary increases should be taken into account an perhaps also increases that usually arise from increasing age or length of service, other increases should not. The different treatment reflect which increases that employer has little or no discretion to avoid.
- 8.38 The backload correction in not directly about whether future salary increases should be taken into account, but how benefits should be attributed to periods of service. For defined contribution plans, IAS 19 requires that the amounts required to be contributed for each period of service are used to attribute an expense and additional liability. For defined benefit plans, if an employee's service in later years will lead to a materially higher level of benefit than in earlier years, an entity shall attribute benefit on a straight-line basis (backload correction).
- 8.39 Although the backload correction is not directly about whether the effect of future salary increases should be reflected in the measurement of liabilities and of expenses, it is indirectly. An argument in favour of the backload correction is namely that without it, the effect of expected future salary increases would not be reflected.

- 8.40 Another argument in favour of the backload correction is that it neutralises any arbitrary allocation of benefits following from a pension plan's benefit formula. As noted in paragraph 7.31, the allocation of benefits under the plans considered in this Discussion Paper, does affect the final pension obligation and an allocation based on a plan's benefit formula, might therefore not be considered 'arbitrary'.
- 8.41 An argument against the backload correction is that it is inconsistent with how defined contribution plans are accounted for. The benefits to be received under a defined contribution plan could also be backloaded, yet IAS 19 does not allow/require entities to attribute the benefits on a straight-line basis under defined contribution plans.

Issues with the backload correction

- 8.42 Regardless of whether there is consensus about the view described above, there are concerns on the lack of clarity of the scope of application of the backload correction. Later service can result in higher benefits in different ways:
- (a) The plan may guarantee higher benefits in later years, such as a higher guaranteed return;
 - (b) The plan may increase the percentage of contributions in later years;
 - (c) The plan may determine the level of benefits based on the salary.
- 8.43 A plan may link the level of benefits to the salary in different ways. In the past, plans were commonly offering benefits that depended on the salary of the final year in service, or close to it. Other formulas are career average salary schemes (some include a revaluation adjustment and are referred to as CARE - or career average revalued earnings schemes). In other cases, however, the benefit is calculated in relation to the current salary for each year of service.
- 8.44 In all these cases, 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 backload correction. Paragraph 70(b) requires to stop the backload correction at the date when further service by the employee will lead to no material amount of further benefits, other than from further salary increases; however, paragraph 87(b) requires to measure the defined benefit obligation on a basis that reflects any estimated future salary increases that affect the benefits payable.
- 8.45 IAS 19 clarifies the treatment of final salary schemes with an illustrative example of a plan that provides a monthly pension of the final year salary for each year of service. The illustrative example is clear in indicating that the benefit allocated to each year of service should reflect the estimated final year salary. However, this does not solve the issue in relation to career average or current salary schemes.
- 8.46 One additional concern is that the backload correction results in a pattern of service costs that is quite different from that of cash payments for contributions. If investors are using the service cost as a proxy to project future pension cash outflows, then it may be argued that a similar pattern of recognition could improve the relevance. On the other side, explaining the nature of the difference between the two in the notes could also provide adequate information.

What has the IASB been doing on the issue?

- 8.47 The inclusion of future salary increases in the measurement of the pension obligation was considered by the IFRS IC as part of its deliberations leading to draft Interpretation D9. However, the IFRS IC decided to stop its project because the IASB was undertaking a revision of IAS 19.
- 8.48 Paragraph 120 of the Basis for Conclusions notes that the Board decided not to address the issue of whether the straight-line application in paragraph 70(b) applies to a formula expressed as a constant proportion of the current salary in each year of service.

APPENDIX 1: CURRENT GUIDANCE

- A1.1 Current financial reporting requirements related to employee benefits considered in this section are IAS 19 *Employee Benefits* under IFRS Standards and ASC 715 *Compensation – Retirement Benefits* under US GAAP.
- A1.2 IAS 19 distinguishes between two types of post-employment benefit plans:
- a) defined contribution plans which are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have not legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods;
 - b) defined benefit plans which are post-employment benefit plans other than defined contribution plans.
- A1.3 The plans covered by this Discussion Paper would (typically) not meet the definition of a defined contribution plan, and would therefore have to be accounted for as defined benefit plans.
- A1.4 For a defined benefit plan under IAS 19, an entity is assumed to promise employees a specific benefit at retirement. Plans can be either funded or unfunded. The entity is assumed to bear the investment risks. The entity uses actuarial techniques to estimate the final benefit entitlement that the employees are expected to receive at retirement. This estimated amount is then discounted to present value using market yields on high quality corporate bonds.
- A1.5 Each period, employees earn a portion of this estimated amount as a result of the service that they have provided to the entity even though they will not receive the amount until they retire. This portion is recognised as current service cost in the statement of profit or loss and is computed using a projected unit credit method. The projected unit credit method is an actuarial valuation method that sees each period of employee service as giving rise to an additional unit of benefit entitlement and measures each unit separately to build up the final pension obligation. Therefore, since the employees only receive their employee benefits upon retirement, a pension obligation is recognised over the period of service.
- A1.6 If the employee benefits in later years is materially higher than the earlier years, the current service cost is recognised on a straight-line basis based on the number of years of the plan (i.e. applying a backload correction).
- A1.7 The plan assets are assets held by a fund that is legally separate from the reporting entity. These plan assets are measured at fair value.

- A1.8 The net pension liability for defined benefit plans recognised in the statement of financial position is therefore the pension obligation less the plan assets and this is remeasured every reporting period. The entity may also have a surplus in a defined benefit plan, i.e. the plan assets being higher than the pension obligation resulting in a net defined benefit asset. In that case, the net defined benefit asset would be the lower of the surplus in the defined benefit plan and the asset ceiling which is the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.
- A1.9 Another set of financial requirements is ASC 715 under US GAAP. There are a number of similarities and differences between IAS 19 and ASC 715. While there are few differences with respect to the measurement of defined benefit plans, there are key differences with regards to cost recognition and presentation¹³.
- A1.10 The table below provides some insight on current requirements for employee benefits under IAS 19 and ASC 715¹⁴.

Title	IAS 19	ASC 715
Defined benefit versus defined contribution plan classification		
Classification	Post-employment plans are classified as either defined contribution or defined benefit plans.	Like IAS 19, <i>post-retirement</i> benefits are classified as either defined contribution or defined benefit plans. However, unlike IAS 19, <i>post-employment</i> ¹⁵ benefit plans are not required to be classified as defined contribution or defined benefit plans; instead, they are accounted for based on the type of benefit.
Pension plans that have elements of both traditional defined contribution plans and traditional defined benefit plans (i.e. 'hybrid' plans)		
Guidance	There is no explicit guidance. IAS 19 only makes a classification between defined contribution or defined benefit plan.	There is limited guidance for specific types of plans. For example, for floor-offset plans (that are economically equivalent to asset-return promises), the plan is accounted for as two separate plans, (i.e., defined benefit for the guarantee and defined contribution for the base plan). ¹⁶
Measurement of benefit obligation		
Actuarial valuation method to determine the present value of the defined benefit obligation	Projected unit credit method	Like IAS 19, projected unit credit method with the exception of certain cash balance plans for

¹³ PwC's IFRS and US GAAP: similarities and differences 2018

¹⁴ This section has been based on the following documents: (i) PwC's *IFRS and US GAAP: similarities and differences 2018*; and (ii) KPMG's *IFRS compared to US GAAP 2017*

¹⁵ 'Post-employment benefits' include benefits payable after employment but before retirement; 'post-retirement benefits' are benefits payable after retirement.

¹⁶ Canadian Accounting Standards Board paper *Research on Pensions: Hybrid Plans* for the July 2018 ASAF meeting

Title	IAS 19	ASC 715
Assumptions	Entity's best estimates of future variables and should be unbiased and mutually compatible. It takes into account estimated future salary increases.	which the traditional unit credit method is used. Unlike IAS 19, <i>each</i> assumption is a best estimate assumption judged on its own. It reflects estimated future salary increases.
Discount rate	The obligation is discounted using High Quality Corporate Bond rate, or a government bond rate if High Quality Corporate Bond market not deep enough. The depth of the High Quality Corporate Bond market is assessed at currency level. The currency and maturity of the bonds should be consistent with the currency and maturity of the defined benefit obligation.	Like IAS 19, the obligation is discounted using a High Quality Corporate Bond rate, however, there is no guidance when the High Quality Corporate Bond market is not deep. Also, like IAS 19, the currency and maturity of the bonds match the currency and maturity of the pension obligation.
Plan assets		
Asset ceiling	If a plan is in surplus, then the amount recognised as an asset in the statement of financial position is limited to the asset ceiling. This is the present value of any economic benefits available to the entity in the form of a refund from the plan or a reduction in future contributions to the plan.	Unlike IAS 19, there is no limitation on the size of the net pension asset that can be recorded on the statement of financial position. An asset is recognised if the plan is overfunded.
Valuation of assets	Plan assets should be measured at fair value, which is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.	Like IAS 19, plan assets are primarily measured at fair value. However, unlike IAS 19, plan assets used in plan operations (for example, buildings, equipment, leasehold improvements) are measured at cost less accumulated depreciation.
Expense recognition		
Cost recognised	The defined benefit plan cost is made up of the following components: Service cost – current service cost, past service cost and gain or loss on settlements (profit or loss) +/- Net interest on net defined benefit liability/(asset) (profit or loss) +/- Remeasurements (OCI)	The periodic cost of defined benefit plans is made up of the following: Current service cost (profit or loss) + Interest cost (profit or loss) - Expected return on plan assets (profit or loss) +/- Actuarial gains and losses (OCI) + Prior (past) service cost (OCI) +/- Gain or loss on curtailment and settlement (profit or loss)
Past (prior) service cost	Immediate recognition in income for the effects of plan amendments that create an increase (or decrease) to the benefit obligation (i.e., prior service cost).	Initially recognised in OCI and then amortised into income over future periods.

Title	IAS 19	ASC 715
Interest	The discount rate is applied to the net benefit obligation to calculate a single net interest cost or income.	Unlike IAS 19, instead of net interest, an entity recognises (i) interest cost (based on the application of a discount rate to the projected benefit obligation; and (ii) expected return on assets (based on the application of an expected long-term rate of return on assets to the calculated asset value).
Remeasurements/ Recognition of gains and losses	Remeasurements comprise: (i) actuarial gains and losses on the defined benefit obligation; (ii) the return on plan assets, excluding amounts included in net interest; and (iii) any change in the effect of the asset ceiling. These remeasurements are recognised immediately in OCI and are not subsequently reclassified to profit or loss.	This comprises: (i) actuarial gains and losses on the defined benefit obligation; and (ii) the return on plan assets. The guidance permits companies to either (i) record gains/losses in the period incurred within OCI or (ii) defer gains/losses through the use of the corridor approach.

Presentation in the income statement

Presentation in the income statement	IAS 19 does not specify where service cost and net interest are presented.	Prior to adoption of ASU 2017-07 ¹⁷ , all components of net benefit cost must be aggregated and presented as a net amount in the income statement. Post adoption of ASU 2017-07, there are specific presentation requirements.
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¹⁷ This amendment to employee benefits is effective for annual periods starting 15 December 2017 (public interest entities) or after 15 December 2018 (other entities); early adoption is permitted.

APPENDIX 2: JOURNAL ENTRY EXPLANATIONS FOR FULFILMENT VALUE APPROACH

A2.1 Taking Year Three in the example, below are explanations for the journal entries under the Fulfilment Value approach.

A2.2 BS stands for Balance Sheet and P&L for profit or loss.

		Account	Explanation
1	DR	Bank (BS)	Receipt of employee contributions
	CR	Pension obligation (BS)	
2	DR	Plan assets (BS)	The employer and employee contributions are invested in plan assets
	CR	Bank (BS)	
3	DR	Current service cost (P&L)	Recognition of current service cost for the period based on the employer contributions made that year
	CR	Pension obligation (BS)	
4	DR	Plan assets (BS)	Return on plan assets
	CR	Interest income (P&L)	
5	DR	Financial expense (P&L)	Accretion of interest on the pension obligation ¹⁸
	CR	Pension obligation (BS)	
6	DR	Financial expense (P&L) ¹⁹	Change in estimates of inflows and outflows. In the example, this relates to changes in the final benefit entitlement amount (i.e. the outflows) and excludes changes to the minimum return guarantee
	CR	Pension obligation (BS)	
7	DR	Financial expense (P&L) ²⁰	Effect of change in discount rate for pension obligation (excluding the effect of changes in discount rate for the value of the minimum return guarantee)
	CR	Pension obligation (BS)	

¹⁸ This includes the time value component of the value of the minimum guaranteed return.

¹⁹ As an alternative, it could be required to account for this component in OCI.

²⁰ As an alternative, it could be required to account for this component in OCI.

		Account	Explanation
8	DR	Current service cost (P&L)	Value of minimum return guarantee recognised as current service cost in profit or loss
	CR	Pension obligation (BS)	
9	DR	Pension obligation (BS)	Remeasurement of the value of the return minimum guarantee (which comprises effect of changes in discount rates and changes to the intrinsic value)
	CR	Financial expense (P&L) ²¹	

²¹ As an alternative, it could be required to account for this component in OCI.

APPENDIX 3: GLOSSARY OF TERMS

Term used in the DP	Explanation
Asset-return promise	A post-employment benefit which amounts to the higher of the return on an identified item or group of items – for example, a portfolio of equities; and a minimum guaranteed return.
Backload correction	Attributing the expected benefit entitlement on a straight-line basis based on the number of years of the pension plan.
Defined benefit cost	The net cost associated with the pension plan and comprises service cost, net interest and remeasurements of the net pension liability.
Final benefit entitlement	The expected future payments to employees required to settle the obligation resulting from employee service.
Financial expense	Is interest expense plus/minus changes in estimates plus/minus remeasurement of the minimum guaranteed return.
Net financial expense	Is the return on plan assets minus financial expense.
Net interest expense	Is the return on plan assets less interest expense.
Minimum guaranteed return	The lowest return on contributions made by the employee and the employer that the employee (or beneficiary) will receive after the completion of employment. In the example, this is 5.5%.
Minimum return guarantee	The fair value of the guarantee which relates to past contributions.
Net pension liability	Plan assets less pension obligation.

APPENDIX 4: ACKNOWLEDGMENTS

- A4.1 This Discussion Paper was prepared by the staffs of the European Financial Reporting Advisory Group (EFRAG) as part of Europe's proactive work in financial reporting.
- A4.2 The project team was assisted by EFRAG Pension Plans Advisory Panel members and observers:

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