IFRS IC – POTENTIAL AGENDA ITEM REQUEST

09. Sitzung IFRS-FA vom 21.09.12
09_07a_IFRS-FA_PAIR IAS 19_PAIR

1 The issue

IAS 19 – Actuarial assumptions: discount rate

1.1 Narrowing market for 'high quality corporate bonds'

According to IAS 19.78[1], the rate used to discount post-employment benefit obligations (both funded and unfunded) shall be determined by reference to market yields at the end of the reporting period on high quality corporate bonds. In countries where there is no deep market in such bonds, the market yields (at the end of the reporting period) on government bonds shall be used. The currency and term of the corporate bonds or government bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations.

The IFRS do not specify which capital market emissions qualify to be 'high quality corporate bonds' (HQCB), so that the term needs to be interpreted. In our jurisdiction and according to the prevalent opinion listed corporate bonds are considered to be HQBC if they are rated 'AA' or equivalently. This view is largely based on the guidance provided in US-GAAP[2] and in the UK FRS 17 *Retirement Benefits*[3]. The information needed for Euro-emissions is often taken from the 'AA'-universes provided by e.g. Barclays, Markit iBoxx or Bloomberg.

However, in the aftermath of the financial crisis and due to related developments (e.g. corporate downgrading, sovereign ceilings), number and volume of corporate bonds rated 'AA' has shrunk in the recent past significantly, including the bonds with maturities of more than ten years which are very important in determining the discount rate for post-employment benefit obligations (as an example: per early July 2012 iBoxx provided for 'AA' rated corporate bonds with maturities more than ten years only 6 Euro-issuers, accounting for 9 emissions and accounting for a trading volume of approx. 8 Mrd. Euro (US: Billion Euro)).

In addition, in the recent past the 'AA' rated bonds are traded less frequently which ist mainly due to market participant's prevailing preference to hold such bonds until their maturity. As a

[1] We refer to IAS 19 (revised 1998). The corresponding paragraphs of IAS 19 (revised 2011) are para. 83ff.
[2] See ASC 715-20-S99; formerly referred to as EITF Topic D-36.
[3] See FRS 17 Appendix IV para. 21.

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consequence single trades could influence the market yield more significantly than in the past and eventually distort the observable market rate and so the discount rate. This development also has contributed to the current situation that the market for 'AA' rated bonds is less deep than it used to be.

In light of the above, concerns are rising that the procedure as described above to determine the discount rate does not generate appropriate results anymore - the discount rate is considered to be distorted and it appears there is no deep market anymore for HQCB (as interpreted above: being rated 'AA') with sufficiently long maturities.

In practice different solutions for this situation have partly be put into practice, are in the process of being implemented or are currently discussed:

View A: Expansion of the HQCB-universe

It is generally preferred to derive the discount rate of a bond universe with sufficient observable data points, this is specifically true for long termed bonds. Therefore, the universe of HQCB is enlarged to also include 'AAA' and 'A' and even 'BBB' rated corporate bonds resulting in a significantly increased amount of observable data points, specifically for long termed bonds. While it generally appears to be acceptable to also include 'AAA' rated bonds, the truly controversial issue is whether bonds rated 'A' or even 'BBB' can be considered to be HQCB and can become part of the universe reference is made to.

In the case of also using 'A' and 'BBB' rated bonds to determine the discount rate used to discount post-employment benefit obligations the additional credit spread between 'AA' and 'A'/'BBB' is deducted from the observed market yield of the 'A'/'BBB' bonds.

View B: Using government bonds

According to view B it is assumed there is no deep market in HQCB anymore and, in accordance with IAS 19.78 sentence 2, government bonds need to be used in determining the discount rate. According to IAS 19.78 the currency and term of the bonds should be consistent with currency and the estimated term of the post-employment benefit obligations. The IFRIC concluded in June 2005 that the reference to 'in countries' could include a region where a single currency is used (such as the Eurozone).

There are opinions that based on the view of the IFRIC (June 2005) government bonds not only from one specific jurisdiction in the Eurozone must be used, but also every government bond denoted in Euro may be taken into consideration. In Europe government bonds are

issued by different countries with different ratings (ranging from 'AAA' to 'CCC'). The issue is, how this wide range of ratings for the different countries shall be taken into account when the discount rate is being determined based on the market yields of bonds issued in the Euro-zone. Questions to be answered in this context relate – for example – to the following: Must the government bonds used have a minimum quality like an 'investment grade' or must their have rating of at least 'AA'? A more general issue relates to the body of the issuer, i.e. whether the issuer of the 'government bonds' must be the federal government or bonds issued by the state government or even on a municipal level are acceptable as well.

View C: There is no issue

According to view C it is assumed there is still a deep market in HQCB and, therefore, changes in determining the discount rate are not necessary.

1.2 Change in accounting estimate

In the case an entity alters it's approach to determine the discount rate (IAS 19.78), specifically in response to (significant) changes in market conditions, the question needs to be addressed, whether such alterations are to be considered changes in accounting estimates or changes in accounting policy (IAS 8).

In this context we consider changes to the methodology triggered by changes in market conditions to be appropriate if they result in more reliably reflecting the time value of money (IAS 19.79) and therefore, support considering it to be a change in accounting estimate (IAS 8).

1.3 Conceptual Issue

Changes in the financial markets since the time when IAS 19 was developed (back of the 1990's) result in a more conceptual issue. In general, when a discount rate is intended to reflect only the time value of money the discount rate is seen to be a risk-free rate.[4] According to IAS 19.79 the discount rate reflects the time value of money, what implicates the rate to discount the post-employment benefit obligations should be a risk-free rate. However, due to the determination of the discount rate by reference to the market yields on HQCB, a premium in addition to the risk-free rate is included in the discount rate, which nowadays is of some significance, detailed in the following. [5]

[4] With respect to the view that a discount rate reflecting the time value of money is a risk-free rate, please refer, for example, to ED/2010/8 *Insurance Contracts* para. 30 and the Basis for Conclusions of ED/2010/8 *Insurance Contracts* para. BC98.

[5] See FRS 17 Appendix IV para. 21.

At the time when the requirements for the discount rate in IAS 19 were developed the credit spreads for 'AA' rated corporate bonds were rather small and negligible. Hence the discount rate included only a small premium for the credit spread and was very close to the risk-free rate, e.g. reflected almost only the time value of money. In the aftermath of the financial crisis the credit spreads for 'AA'-rated corporate bonds increased significantly. As a consequence, the discount rates comprise much higher risk premiums and move away from reflecting mainly the time value of money.

This change leads to the question, whether the shift from a mainly risk-free rate for discounting post-employment benefit obligations, as it was intended when the standard was developed, to a discount rate including a significant premium for credit risk nowadays still is in line with the intention underlying IAS 19.

Against this background, in our view it would be very helpful if the IFRS IC could clarify the underlying intention in determining the rate to discount post-employment benefit obligations (i.e. whether the discount rate should be a risk-free rate or should include a risk premium for credit risk pertaining to the market yields on HCQB referenced to).

Another general issue is whether 'high quality' is to be understood absolutely, i.e. only bonds with a rating of at least 'AA' given by an internationally recognised ratings agency are considered to be of 'high quality', or relatively, i.e. bonds of high quality in the relevant/local market are considered to be HQCB even if those bonds would get a rating of – for example – 'BB' if rated by an internationally recognized ratings agency.

2 Current practice

The outcome of a request for information circularised to other national standard-setters confirms the view that there is diversity in practice. In several countries a deep market in HQCB never existed and therefore government bonds were always used to determine the discount rate. In a few other countries deep markets in HQCB still exist and, thus, no problems are evident. Other countries used to have a deep market in HQCB in the past and now are confronted with a narrowing market. A few of the entities in the latter countries expanded the universe of HQCB to 'AAA' and 'A'-rated corporate bonds. Others use the rates of government bonds plus a spread to adjust for the additional credit risk associated with corporate bonds.

The national standard-setters providing feedback to the request consider a change in the bond universe used as the reference basis to determine the rate to discount post-employment benefit obligations to be a change in accounting estimate.

3 Reasons for the IFRS IC to address the issue

3.1 Is the issue widespread and has it practical relevance?

Based on investigations and inquiries made (a request for information was circularised to other NSS), it was confirmed that the issue as described in this document is widespread and of practical relevance. Based on our investigations the issue applies to a whole number of jurisdictions world-wide.

3.2 Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?

As outlined above there are at least three views A to C, which lead to the expectation that significantly divergent interpretations are existent or are in the progress to emerge.

3.3 Would financial reporting be improved through elimination of the diversity?

Financial reporting would be improved by clarifying this issue since determining the discount rate for post-employment benefit obligations would be based on harmonised approaches in line with the requirements of IAS 19. If divergent interpretations and practices will not be prevented, information about a reporting entity may not be compared with similar information about other entities. Therefore, an appropriate clarification would enhance comparability among companies' financial reporting.

3.4 Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and Framework for the Preparation and Presentation of Financial Statements, but not so narrow that it is inefficient to apply the interpretation process?

We are of the opinion that the issue is sufficiently narrow in order to be addressed by the IFRS IC.

3.5 If the issue relates to current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project? (The IFRS IC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRS IC would require to complete its due process).

N.A.

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