EFRAG PAPER FOR PUBLIC MEETING

EFRAG Research Activities

Pensions – Work plan

Objective

1 At the October and December 2015 EFRAG TEG meetings, EFRAG Secretariat presented a draft work plan for a pro-active project on accounting for pensions. EFRAG TEG agreed to recommend to the Board to start the project and suggested some changes to the work plan.

2 The objective of this session is to discuss the amended work plan and approve the project.

Background and description of the issue

3 In Europe, entities are allowed or required to provide employees with post-employment benefits (post-employment benefit plans or programs). Among others, those benefits may include:

(a) services or consumables provided at special discounted prices;

(b) health services or funded health insurances;

(c) pension plans i.e. funding or partial funding of retirement benefit plans in the form of a lump sum or an annuity payable after retirement.

4 A variety of post-employment benefits are present in Europe. However, pension plans, mentioned in paragraph 3(c) above, seem to be a dominant and common form of private post-employment benefit plans. The overall fair value of the assets of those plans (e.g. investments in financial instruments, real estate etc.) becomes an important element of the European economy. It is estimated that at the end of 2012, 5,335 billion Euro of assets were managed in countries for future workplace private pension payments[1].

5 The structure of pension plans can be different. They include single-employer plans, multi-employer plans, state plans, or cross-border (i.e. pan-European) plans. A plan may be also structured to share the risks between various entities under common control. IAS 19 *Employee Benefits* addresses how to account for plans that cover the obligations of multiple entities.

6 The design of pension plans may also vary and, in consequence, the plans may have significantly different characteristics with respect to (but not limited to):

(a) the risks faced by employers and employees;

[1] Pensions Europe Statistical Survey 2014

(b) the sensitivity of benefits to inflation; or

(c) the flexibility of funding.

7 EFRAG Secretariat has had preliminary discussions with constituents in the Netherlands and Switzerland, who raised a number of issues, especially in relation to the application of the requirements to so-called 'hybrid plans' (plans that have some features of defined contribution schemes and some features of defined benefit schemes). In 2014, EIOPA identified 16 plans as hybrid and 45 plans as defined contribution with guarantees out of the total 244 accounted for[2].

Interaction with the IASB Research programme

8 The IASB has currently one project on its Research programme on Pensions. The objective of the IASB project is to consider whether it is possible to develop a solution for hybrid plans without reconsidering the general requirements for post-employment benefit plans. If not, a more fundamental revision will be considered. In December 2015, the IASB considered a staff paper that outlined the problem and some accounting models considered in the past to address this.

9 The IASB decided that they would wait for the results of their 2015 Agenda consultation before deciding the next steps on their pensions project. In its reply to the consultation, EFRAG has indicated that the project on Pensions has a Medium importance and urgency. The IASB will consider the feedback on its Agenda consultation in the second quarter of 2016.

Issues for research

10 In its initial discussion with constituents, EFRAG Secretariat has been advised to consider a number of aspects in the existing guidance in IAS 19.

The dual model

11 IAS 19 draws a strict line between two broad groups of plans and requires to apply two different measurement methods, with a significantly different level of complexity.

12 Some constituents point out that this binary distinction may lead to plans with substantially the same economic characteristics being treated very differently. This is because the introduction of any risk exposure triggers defined benefit accounting, even when the exposure arises from local legislation and is perceived to be remote.

Linked measurement

13 IAS 19 prescribes separate measurement requirements for plan assets and pension liabilities, with the exception of qualifying insurance policies that are measured at the present value of the related obligation.

14 Some constituents have commented that the different measurement requirements for the defined obligation and the plan assets may create what they perceive as accounting mismatches. This concerns both the measurement bases and the discount rate used in their calculation.

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[2] EIOPA Statistical Summary: database of pension plans and products, 2014

15 For instance, in November 2014 the IFRS Interpretations Committee (the IFRS IC) discussed the measurement of longevity swaps held under a defined benefit plan, and if these could be split into two components with the use of another basis of measurement for a qualifying insurance policy for one of the components The IFRS IC concluded that such annuities satisfy the definition of plan assets and, therefore, must be measured at fair value.

16 Measurement of plan assets and pension liabilities could be linked in relation to specific components or specific measurement attributes – such as capping the expected return on plan assets in the measurement of future outflow to the rate used to discount the liability.

Guaranteed returns

17 In some cases, the defined benefit is based on the return of the plan assets but the sponsoring entity guarantees a minimum return. There is uncertainty over whether the measurement of the defined obligation should be based on the guaranteed or the expected return.

Actuarial differences and plan modifications

18 Actuarial losses are recognised in OCI (for instance due to changes in expected longevity"). However, if the entity amends the terms of the plan, the effect is recognised in profit or loss. Some constituents view this as an accounting mismatch and consider that in these cases a portion of the actuarial differences should be recycled.

Proposed work plan

What we intend to investigate

19 The objective of the project is to investigate which characteristics of a pension plan should affect financial reporting and how.

20 Firstly, we intend to assess the relevance of the three elements in the IAS 19 definition of a defined benefit plan in affecting the classification of the plan:

(a) The payment of contributions by the employer;

(b) The existence of the plan as a separate entity; and

(c) The presence or absence of an obligation to pay further contributions in case the fund does not hold sufficient assets to pay all the benefits relating to the services in current and prior periods.

21 We will also consider what other features should affect the accounting, such as:

(a) Whether the employer is exposed only to specific risks, such as investment risk, longevity risk, and financial vs. non-financial risks;

(b) Whether the plan benefits can be settled with a lump-sum if requested by a plan participant;

(c) The existence of a guaranteed minimum return;

(d) The existence of other specific contractual and/or legal requirements; and

(e) If, when and to what extent the measurement of plan assets should be linked to the measurement of the defined obligation.

22 In relation to (e) above, this could be articulated in different ways:

(a) Extending the plan assets that are measured on the basis of the defined benefit obligation;

(b) Requiring some or all of the benefit obligation to be measured at fair value; or

(c) Adjusting the discount rate for the obligation to reflect the expected return of the plan assets.

23 The analysis could result in:

(a) Suggesting a different distinction between defined benefit and defined contribution plans;

(b) Developing a specific solution for a new distinct category of plans with a specific accounting approach;

(c) Identifying the specific approach (or approaches) to depict the characteristics of contractual and/or legal requirements.

24 We will also consider possible improvements to presentation and disclosure requirements.

25 The output is expected to be a discussion paper, with the aim to provide European input into the IASB's Research project.

How we intend to work on the project

26 The project will be approached in three stages that aim to achieve the above objectives. EFRAG TEG will be regularly updated on the status and consulted to recommend the next steps; this assessment is expected to consider also the progress made by the IASB on its Research projects and the best way to provide timely input.

27 During the first stage, EFRAG Secretariat proposes to gather information on the economics of the wide range of pension plans and other post-employment benefit plans in use in Europe. EFRAG Secretariat thinks that it is important to anchor the discussion in the economics of the existing post-employment plans. This phase will require consultation with European National Standard Setters, and other specialists of the topic. We estimate the duration of this stage to be 3 months.

28 During the second stage EFRAG Secretariat plans to collect constituents' views on the model that would better reflect those economics to increase comparability of the financial information reported by the employers, and address the measurement issues. We estimate the duration of this stage to be 5 months.

29 This stage should include both empirical research and practical outreach to European constituents from various industries. EFRAG Secretariat also thinks that this project should consider:

(a) users' opinions on the information that is useful in relation to pension plans;

(b) past EFRAG's and National Standard Setters' discussions and publications on pension accounting, including the PAAinE report from 2009;

(c) past discussions of the IASB and the IFRS IC related to accounting for pension plans with specific characteristics;

(d) findings of the current IASB's Research project on Pensions;

(e) the current debate and developments in the Insurance Contracts project;

(f) relevant US GAAP requirements and guidance; and

(g) academic papers on accounting for pensions and other benefit plans that share risks between the employer and employees.

30 During the third stage, the findings will be used to develop proposals for alternative approaches to address the identified issues and an analysis of the strengths and weaknesses of each proposed approach.

31 The draft discussion paper should be published 3 months after the end of the second stage. We propose a 4 month comment period and two months to consider the comments and issue the feedback statement.

How much time do we need

32 EFRAG Secretariat expects that the project will take at least 5 man days (one week) a month for 12 months. The German Standard Setter has expressed an interest in participating and contributing some resource, but we have not yet discussed the extent of the cooperation.

Resources - Advisory Group

33 In October, EFRAG TEG recommended that EFRAG create an Advisory Group to assist with the project. The Advisory Group should include individuals and organisations with specific knowledge in the topic, and ideally include representatives from each of the following categories:

(a) organisations that provide or deal with the regulatory framework for pensions like EIOPA and Pensions Europe;

(b) users' organisations, such as CRUF and EFFAS;

(c) preparers with practice in different type of post-retirement benefits;

(d) the academic community;

(e) associations of actuaries like the Actuarial Association of Europe (AAE); and

(f) accounting and audit firms.

34 EFRAG Secretariat suggests to liaise with relevant organisations even if they did not submit any candidate for the Advisory Group.

35 In addition, EFRAG Secretariat will involve EFRAG CFSS, the User Panel and EFRAG IAWG to collect input and feedback on the different steps of the project.

Questions for EFRAG Board

36 Do you have comments on the objectives of the project and the preliminary identification of issues?

37 Do you approve to start the pro-active project?

APPENDIX A – TECHNICAL REFERENCES

A. IAS 19 and IFRIC 14 *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* are the relevant pronouncement for the accounting of post-employment benefits.

B. IAS 19 has been revised in 2004 to address accounting for multi-employer and group plans and in 2011 to simplify accounting for net interest on Defined Benefit Liability (DBL) or Asset (DBA) and eliminate the 'corridor' mechanism for actuarial differences.

C. The current requirements do not distinguish between pension plans and other post-employment benefit plans e.g. post-employment health insurance. Paragraphs 27 and 28 of IAS 29 require to classify any post-employment benefit plan as either defined contribution or defined benefit depending on the economic substance of the plan as derived from its principal terms and conditions. A plan will classify as a defined contribution plan when the entity's legal or constructive obligation is limited to the amount that it agrees to contribute to the fund. Any other plan will be classified as a defined benefit plan. The classification is only binary and there is no intermediate category.

D. The classification leads to a dual recognition and measurement model where:

   (a) for *defined contribution plans*, employers are required in accordance with paragraph 51 of IAS 19 to recognise the outstanding liability to make the agreed contribution to the plan;

   (b) for *defined benefit plans*, employers are required to consider actuarial assumptions and apply a complex projected unit credit method to measure the present value of a defined benefit obligation.

E. In accordance with paragraph 57 of IAS 19 employers are required to measure the defined benefit obligation using the projected unit credit method and, namely to:

   (a) make a reliable estimate of the ultimate cost to the entity of the benefit that employees have earned in return for their service in the current and prior periods (paragraphs 67–69);

   (b) determine how much benefit is attributable to the current and prior periods; and

   (c) make estimates (actuarial assumptions) about demographic variables (such as employee turnover and mortality) and financial variables (such as future increases in salaries and medical costs) that will affect the cost of the benefit.

F. The present value of a defined benefit obligation should be calculated using the rate determined by reference to market yields on high quality corporate bonds or, in countries where there is no deep market in such bonds, government bonds. Net defined benefit obligation (asset) should be presented net of the fair value of any plan assets.

G. US GAAP have a positive definitions for each type of plan:

   (a) Defined contribution plans are defined (topic 715-30-20) as plans that provide an individual account for each participant and provide benefits that are based on:

      (i) amounts contributed to the participant's account by the employer or employee;

      (ii) investment experience; and

(iii) any forfeitures allocated to the account, less any administrative expenses charged to the plan.

(b) Defined benefit plans are defined as plans that provide its participants with a determinable benefit based on a formula provided by the plan and, in particular, a defined benefit pension plan should define an amount to be paid.

H. US GAAP clarifies that any pension plan that is not a defined contribution pension plan is, for the purposes of topic 715-30, a defined benefit pension plan.

I. The issues and complexity of the accounting for pension plans that carry the characteristics of both defined benefit plans and defined contribution plans has been recognised. Consequently, subtopic 715-70-15-2 was introduced to provide some limited guidance for such plans. This subtopic, however, only explains that such plans require careful analysis.