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Accounting for Pension Plans with an Asset-return Promise Cover Note

Objective

1 The objective of this session is to receive the initial views of EFRAG CFSS members on the approaches presented in EFRAG's Discussion Paper *Accounting for Pension Plans with an Asset-return Promise* (the 'Discussion Paper').

Background

2 In May 2019, EFRAG published the Discussion Paper.

3 The Discussion Paper considers three possible alternatives to account for defined benefit pension plans promising the higher of the return on plan assets and a guaranteed minimum return. Under these plans the pension obligation is linked to the value of the plan assets, however, this linkage may not be well reflected when the pension plan is accounted for in accordance with IAS 19 *Employee Benefits*.

4 The three alternative approaches considered are:

(a) A Capped Asset Return approach. Under this approach, when measuring the pension obligation, the expected asset return is capped to the high-quality corporate bond rate (used to discount the pension obligation).

(b) A Fair Value Based approach. Under this approach, the pension obligation is measured at the sum of the fair value of the plan assets and the fair value of the minimum guaranteed return.

(c) A Fulfilment Value approach. Under this approach the pension obligation is measured based on the estimated outflows needed to settle the entire pension obligation minus the expected future inflows over the life of the pension plan.

5 One of the objectives of the Discussion Paper is to provide useful input for the IASB's project on pension benefits that depend on assets returns.

6 The executive summary included in the Discussion Paper is provided in the Appendix of this cover note.

Questions for EFRAG TEG/CFSS

7 For the pension plans within the scope of the Discussion Paper:

(a) Which of the three alternative approaches mentioned in paragraph 4 above do you (initially) think should be further considered?

(b) Do you think there are other approaches to account for the pension plans within the scope of the discussion paper that should have been considered in the Discussion Paper?

8	The Discussion Paper deals with asset-return pension plans that hold the assets on which the return is determined. The Discussion Paper focuses on these plans as the risk exposure under these plans is different from plans that do not hold the assets upon which the return is based. Do you think that the three approaches mentioned in paragraph 4 could also be applied (with modifications) to those plans with an asset-return promise, where the plan does not hold the reference assets?
9	Do you have any other comments on the Discussion Paper?

Agenda Papers

10 In addition to this cover note, agenda papers for this session are:

(a) Agenda paper 07-02 – Pension Plans with an Asset-return Promise – Presentation for ASAF (summary); and

(b) Agenda paper 07-03 – Pension Plans with an Asset-return Promise – the Discussion Paper.

Appendix

Executive summary of the Discussion Paper

1 This Discussion Paper explores alternative accounting treatments for post-retirement employee benefits (pension plans) promising the higher of the return on an identified item or group of items and a minimum guaranteed return (referred to as an 'asset-return promise'). The scope of the Discussion Paper is further restricted to plans holding the identified item or group of items upon which benefits are dependent.

2 One of the main perceived issues with accounting for the plans in the scope in accordance with the requirements in IAS 19 *Employee Benefits* is that measurements of the pension obligation and the plan assets do not reflect the economic covariances between the two following from the terms of the plans. One of the reasons is that the final entitlement benefits are projected with the expected returns on plan assets, while the pension obligation needs to be discounted using a high-quality corporate bond rate. Accordingly, when the expected return on the plan assets is higher than the discount rate, a net pension liability needs to be recognised, even if it is expected that the plan assets will be sufficient to fully settle the pension obligation at retirement.

3 This Discussion Paper considers the following three alternatives for accounting for the plans in the scope of the project:

(a) A Capped Asset Return approach;

(b) A Fair-Value Based approach; and

(c) A Fulfilment Value approach.

4 Under all the approaches, the plan assets are measured at fair value in accordance with IAS 19. The Discussion Paper only explores alternatives in measuring the pension obligation.

5 The effects of the three alternatives are illustrated with a numerical example. In the example, the beneficiary receives the contributions made to a pension scheme and the asset-return promise. Each year the employer makes a contribution depending on the employee's salary and years working for the entity. The employee can make additional contributions, which are matched, until a given level, by the employer. The detailed terms of the plan result in it having to be accounted for in accordance with the requirements for defined benefit plans in IAS 19.

6 Under the Capped Asset Return approach, plan assets are measured at fair value similar to under IAS 19. The pension obligation is measured at the higher of:

(a) The pension obligation as it would have been measured using the guidance for defined benefit plans under IAS 19, but capping the expected returns by the high-quality corporate bond rate; and

(b) The pension obligation as it would have been measured under IAS 19, had the pension promise only been to provide the minimum guaranteed return.

7 When the expected return rate is higher than the discount factor, this approach will remove the perceived issue resulting from using a discount factor that is different from the expected return rate. Some of the weaknesses with this approach, compared with the other two approaches, are assessed to be:

(a) A net pension liability will not be reflected in all situations under which the plan assets are insufficient to cover the pension obligation;

(b) The economic covariance between plan assets and the pension obligation will in many cases still not be appropriately reflected. This is because plan assets and pension obligations will be measured differently; and

(c) The employee's right to receive the higher of the return on plan assets and the minimum guaranteed return is not reflected in a complete manner.

8 Compared with the other two approaches, some of the strengths of the approach are assessed to be:

(a) The obligation resulting from the promise of a minimum guaranteed return is accounted for similarly to pension plans not covered by the scope of this Discussion Paper; and

(b) It should be relatively easy to apply the requirements retrospectively and implementation will be less costly than the other two methods.

9 Under the Fair Value Based approach considered in this Discussion Paper, the pension obligation is measured at the sum of the fair value of the plan assets on which the return is based and the fair value of the minimum return guarantee related to the made contributions. The Fair Value Based approach does thus not require a pension obligation to be measured at its fair value, which would reflect the amount an entity would have to pay to transfer the liability to another party. The approach may, however, result in an approximation of such a value.

10 Under the Fulfilment Value approach, the pension obligation is calculated by first estimating the outflows needed to settle the entire pension obligation directly with the employee when it becomes due. From this amount, the expected future inflows over the life of the pension plan are deducted.

11 Under the version of the approach considered in this Discussion Paper, the outflows consist of the expected amount of cash that will be transferred to the beneficiary in the pension plan at retirement and the value of the minimum return guarantee for all paid contributions (i.e. both employer and employee contributions) to date. Expected cash contributions from the employer and the employee's service to be provided over the life of the pension plan in return for the pension benefits are the inflows considered. The value of the employee's service is determined as the value of the future contributions made by the employer to the plan and the value of the minimum return guarantee (for both the employer and employee contributions).

12 The difference between the discounted values of the expected outflows and the expected future inflows is then the pension obligation. Both outflows and inflows are discounted at a rate reflecting the plan assets.

13 Both the Fair Value Based approach and the Fulfilment Value approach would result in a net pension liability being reflected in all situations when the plan assets are (expected to be) insufficient to cover the pension obligation. They would also reflect:

(a) The economic covariance between plan assets and the pension obligation; and

(b) The employee's right to receive the higher of the return on plan assets and the minimum guaranteed return.

14 However, these approaches would:

(a) Account for the promise of a minimum guaranteed return in a different manner than required under IAS 19. This could impede comparability between financial statements for entities with pension plans covered by the scope of this Discussion Paper, and financial statements for other entities; and

(b) Be costlier to implement than the Capped Asset Return approach.

15 The purpose of this Discussion Paper is not to consider the distinction in IAS 19 between defined benefit plans and defined contribution plans, which would involve a comprehensive overhaul of the requirements for accounting for pension plans. However, the Discussion Paper notes that other concerns have been raised in relation to the existing requirements, including the backload correction, that requires attribution of benefits on a straight-line basis if an employee's service in later years will lead to a materially higher level of benefit than in earlier years. The Discussion Paper includes a short description of these concerns.