

# IAS 19: Inflation Rate

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## Extract, IFRS Discussion Group Report on Meeting – May 31, 2016

IAS 19 *Employee Benefits* requires financial assumptions to be based on market expectations. An explicit inflation assumption may be required to measure the defined benefit obligation of a pension plan. Two common approaches used by Canadian pension plan sponsors to determine an inflation assumption are based on:

- a break-even inflation rate (Approach A); or
- long-term considerations, including the Bank of Canada target inflation range (Approach B).

Since the transition to IFRSs in Canada, the above two approaches have generally produced similar results until recent years.

***Question: Which of the two approaches are appropriate in determining the inflation rate assumption for measuring the defined benefit obligation of a pension plan under IAS 19?***

*Approach A – A break-even inflation rate.*

This approach considers that a market-based inflation expectation can be determined by looking at the difference in yields of two long-term Government of Canada bonds (i.e., one nominal and one real-return bond). The difference in yields can be viewed as the market's implicit expectation of the long-term rate of inflation in Canada.

Proponents of this approach note that there are several advantages with Approach A. This approach is based on current market prices of bonds at the measurement date so that inflation expectations of market participants, investors and bond issuers are reflected in the bond yields. In addition, Government of Canada bonds are traded frequently in significant volumes and daily yields on benchmarks of these bonds are easily accessible by the public. Furthermore, proponents think that this approach is consistent with other IFRS jurisdictions that commonly provide inflation indexation (for example, the United Kingdom).

There are some disadvantages with Approach A. For example, during times of market turbulence, the existence of liquidity premiums may create a distortion in the break-even inflation rate measure because investors may demand a higher yield to compensate for the risk they bear. Also, the duration of bond indices that are available to determine this measure may not be sufficiently long to be representative of the duration of obligations. There are also other factors that could affect the prices for nominal and real-return bonds (for example, de-risking of pension plans).

*Approach B – Long-term considerations, including the Bank of Canada target inflation range.*

This approach determines an inflation assumption using a forecast approach by considering the Bank of Canada's policy to estimate long-term inflation. Proponents of this approach often set the long-term

inflation assumption to correspond to the midpoint (i.e., two per cent) of the Bank of Canada's target range of one to three per cent.

Proponents of this approach note that there are several advantages with Approach B. The Bank of Canada has been successful in meeting the inflation target in recent years and is able to apply monetary policy tools to help meet the inflation target in the future. This measure is also not distorted by changes in liquidity premiums.

There are some concerns with Approach B. For example, the Bank of Canada inflation target rate is not a market-based measure and may not be aligned with the long-term views of market participants, investors and bond issuers. A forecast approach for the inflation rate could also create an inconsistency with the discount rate assumption as the discount rate is based on market yields for high-quality corporate bonds. Further, the ability of the Bank of Canada to meet inflation targets could be challenged by external factors such as global economic conditions.

### *The Group's Discussion*

The Group noted that this issue is primarily relevant for indexed plans. Group members asked several questions, including whether:

- there is a predominant actuarial practice in Canada;
- the adjustments to Approach A resulted in a more converged or diverged inflation rate with Approach B; and
- entities performed a reconciliation between the two approaches.

The presenter observed that practice is mixed and that both approaches have been used in Canada. Generally, it is challenging to come up with a precise basis point for adjusting the yield differential (Approach A), but adjustments in Canada have tended to bring the inflation rate closer to the target inflation rate of two percent. However, the adjustment is dependent on market conditions. It is not common to see management perform a reconciliation between the two approaches. However, differences between the two approaches could be indicating that market participants think that the inflation rate will not be near the target inflation rate.

One Group member thought that paragraph 76 of IAS 19 provides some flexibility because actuarial assumptions are based on an entity's best estimates. Financial assumptions are based on market expectations, with the discount rate specifically referring to market yields. Therefore, the Bank of Canada's target inflation rate could be viewed as some form of market expectation, albeit not necessarily market yields. Another Group member has seen more of a survey-based approach (i.e., Approach B) where respondents like economists make many observations of the market, and they generally do not veer from the Bank of Canada target inflation rate of two per cent. However, consideration should be given as to when the survey is conducted in relation to the measurement date of the defined benefit obligation to ensure the information is sufficiently current.

One Group member observed that given a more precise discount rate is computed at each measurement date, it seems counterintuitive to use a fixed inflation rate. It would seem more appropriate to find a more precise inflation rate that is inherent in the discount rates to achieve

consistency in the actuarial assumptions. Another Group member noted that while Approach B is commonly seen in practice, the break-even inflation rate should be considered in applying Approach B as it could provide additional useful information on determining an appropriate inflation rate estimate, particularly given the changes to the bond yields in the current market conditions.

The Group noted that the IASB has a research project on post-employment benefits (including pensions) and pointed out that more guidance on determining assumptions like the inflation rate would be helpful.

The Group's discussion raises awareness about this item. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the [audio clip](#)).