Project **Post-employment Benefits**

Topic **Risk disclosures**

Objective

1. The objective of this paper is to discuss appropriate risk disclosures for defined benefit plans.

Introduction

2. The first section discusses disclosures about estimation risks. To provide information on such risks, currently IAS 19 requires the disclosure of principal actuarial assumptions which may include mortality rates.

3. The second section discusses the disclosure of a sensitivity analysis. Some believe that a sensitivity analysis will provide users with information to assess the estimation and market risks associated with the defined benefit liability.

4. The third section discusses disclosures to assist in assessing risks arising from regulation. Some believe that regulation may impact the risks of a post-employment benefit plan, where post-employment benefit plans are heavily regulated.

5. The fourth section discusses the disclosure of restrictions on the entity's use of the plan assets and defined benefit obligation to assist in examining the impact of restrictions on a defined benefit plan's risk.

6. The fifth section discusses disclosures on asset-liability matching which may be useful for assessing the entity's future contributions to meeting future payments.

7. The final section considers whether the disclosures proposed in Exposure Draft 10 *Consolidated Financial Statements* on the nature and risks associated with an

entity's involvement with structured entities that are not controlled are also useful for post-employment benefits.

8. Agenda paper 7A discusses alternative risk disclosures developed for defined benefit plans by the marketplace.

Estimation Risks

Actuarial assumptions

9. The disclosure of principal actuarial assumptions is useful in understanding the estimation risk in the calculation of the defined benefit liability. IAS 19 paragraph 120A requires the following disclosures on the actuarial assumptions used:

> ….
>
> **(n) the principal actuarial assumptions used as at the end of the reporting period, including, when applicable:**
>
> > **(i) the discount rates;**
> >
> > **(ii) the expected rates of return on any plan assets for the periods presented in the financial statements;**
> >
> > **(iii) the expected rates of return for the periods presented in the financial statements on any reimbursement right recognised as an asset in accordance with paragraph 104A;**
> >
> > **(iv) the expected rates of salary increases (and of changes in an index or other variable specified in the formal or constructive terms of a plan as the basis for future benefit increases);**
> >
> > **(v) medical cost trend rates; and**
> >
> > **(vi) any other material actuarial assumptions used.**
>
> **An entity shall disclose each actuarial assumption in absolute terms (for example, as an absolute percentage) and not just as a margin between different percentages or other variables.**
>
> **(o) the effect of an increase of one percentage point and the effect of a decrease of one percentage point in the assumed medical cost trend rates on:**
>
> **(i) the aggregate of the current service cost and interest cost components of net periodic post-employment medical costs; and**

> **(ii) the accumulated post-employment benefit obligation for medical costs.**
>
> **For the purposes of this disclosure, all other assumptions shall be held constant. For plans operating in a high inflation environment, the disclosure shall be the effect of a percentage increase or decrease in the assumed medical cost trend rate of a significance similar to one percentage point in a low inflation environment.**
>
> …

Mortality Risks

10. IAS 19 requires the disclosure of principle assumptions which may include mortality rates. Some believe that IAS 19 should be amended to require specifically the disclosure of mortality rates, for example standard metrics such as life expectancy for a 65 year old retiring now or in 10, 20, 30 years time (see agenda paper 2A).

11. However, some do not support requiring the disclosure of mortality rates as the costs may outweigh the benefits. They argue that:

    (a) for plan members with disparate demographic profiles, the disclosure of aggregated mortality rates is less useful

    (b) if users are to understand and use information about mortality rates, they would need detailed knowledge about the demographics of the plan. It is not practicable to provide sufficient information for users to acquire the necessary knowledge. As a result, comparisons based on such disclosures are likely to be uninformative and perhaps misleading.

12. To understand the difficulties of using and applying mortality data, consider the following example. Entities A and B estimate mortality rates for their pension plans using a blend of the most recent published mortality tables and their own experience:

    (a) Entity A is an industrial company. 60% of its workers are in social classes C and D. Its largest factory is in the North of England. 15% of its work force was born between years 19XX and 19YY (national tables show that individuals born between those years have much lower life expectancy than those born in immediately preceding or following years.) Entity A has been operating its pension plan for 100 years and has a work force of 70,000. In developing its mortality estimates, it gives a 70% weighting to national tables and a 30% weighting to its own data.

(b) Entity B is a service company. 80% of its workers are in social classes B and C. Its main location is in the South of England. 2% of its work force was born between years 19XX and 19YY. Entity B has been operating its pension plan for 17 years and has a work force of 10,000. In developing its mortality estimates, it gives a 90% weighting to national tables and a 10% weighting to its own data.

13. Entity A estimates that the life expectancy of a 65 year old male smoker is currently 20 years and entity B estimates that life expectancy of a 65 year old male smoker is currently 23 years. Presumably, users would compare the two life expectancies and attempt to assess whether entities A and B made conservative or optimistic estimates. What information would users need to be able to make these assessments?

14. Another approach would focus on disclosing the process used to derive assumptions (complemented by sensitivity analysis (discussed in paragraphs 16-17) and disclosures about changes in estimates), rather than on disclosing the absolute level of assumptions. The Board faced similar issues when it developed IFRS 4 *Insurance Contracts.* Paragraph 37(c) of IFRS 4 requires an insurer to disclose: "the process used to determine the assumptions that have the greatest effect on the measurement of the recognised amounts described in (b). When practicable, an insurer shall also give quantified disclosure of those assumptions."

15. Paragraphs BC211 and BC212 of IFRS 4 provides the following explanation [footnotes omitted]:

> BC211 … The disclosure of assumptions both assists users in testing reported information for sensitivity to changes in those assumptions and enhances their confidence in the transparency and comparability of the information.
>
> BC212 Some expressed concerns that information about assumptions and changes in assumptions might be costly to prepare and of limited usefulness. There are many possible assumptions that could be disclosed: excessive aggregation would result in meaningless information, whereas excessive disaggregation could be costly, lead to information overload, and reveal commercially sensitive information. In response to these concerns, the disclosure about the assumptions focuses on the process used to derive them.

Discussion questions
1. Would users make use of information about mortality rates?
2. If so, how would they use it and what contextual information would they need to make use of the disclosures about mortality rates?
3. Do you believe that disclosures on mortality rates should be specified for defined benefit plans?
4. If so, what should be disclosed?
5. Do you believe that there are other key assumptions that should be specifically required to be disclosed?
6. Would it be more useful to require qualitative disclosures on the process used to derive assumptions (IFRS 4 approach) than to specifically require the disclosures of key assumptions in absolute terms (IAS 19 approach)?

Sensitivity analysis

16. Some believe that requiring a sensitivity analysis to disclose a range of outcomes for the calculation of the defined benefit liability would be useful to help users understand the estimation and market risks associated with the defined benefit liability. However, some believe that the disclosure of such a sensitivity analysis would be costly.

17. The following is an example of a sensitivity analysis reproduced from the ASB Reporting Statement *Retirement Benefits—Disclosures* (see agenda item 2E).

Illustration 3—Sensitivity analysis of the principal assumptions used to measure scheme liabilities

The sensitivities regarding the principal assumptions used to measure the scheme liabilities are set out below:

Assumption	Change in assumption	Impact on scheme liabilities
Discount rate	Increase/decrease by 0.5%	Increase/decrease by 9.5%
Rate of inflation	Increase/decrease by 0.5%	Increase/decrease by 5.5%
Rate of salary growth	Increase/decrease by 0.5%	Increase/decrease by 3%
Rate of mortality	Increase by 1 year	Increase by 4.5%

For each sensitivity the impact of a change in a single factor is shown with other assumptions unchanged.

Discussion questions	
7.	Do you think that a sensitivity analysis should be disclosed for defined benefit plans?
8.	If so, what should be the inputs into such a sensitivity analysis?

Regulatory disclosures

18. In some jurisdictions post-employment benefits are subject to more regulation than in others. Some believe that the financial statements should disclose information on the regulatory funding arrangements for defined benefit plans to help users better understand risks associated with the defined benefit liability (eg regulation may constraint the entity's actions in some way). For example, they would like disclosures similar to the capital disclosures required in IAS 1 *Financial Statements: Presentation* set out below:

Capital

134 An entity shall disclose information that enables users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital.

135 To comply with paragraph 134, the entity discloses the following:

(a) qualitative information about its objectives, policies and processes for managing capital, including:

(i) a description of what it manages as capital;

(ii) when an entity is subject to externally imposed capital requirements, the nature of those requirements and how those requirements are incorporated into the management of capital; and

(iii) how it is meeting its objectives for managing capital.

(b) summary quantitative data about what it manages as capital. Some entities regard some financial liabilities (eg some forms of subordinated debt) as part of capital. Other entities regard capital as excluding some components of equity (eg components arising from cash flow hedges).

(c) any changes in (a) and (b) from the previous period.

(d) whether during the period it complied with any externally imposed capital requirements to which it is subject.

(e) when the entity has not complied with such externally imposed capital requirements, the consequences of such non-compliance.

The entity bases these disclosures on the information provided internally to key management personnel.

136 An entity may manage capital in a number of ways and be subject to a number of different capital requirements. For example, a conglomerate may include entities that undertake insurance activities and banking activities and those entities may operate in several jurisdictions. When an aggregate disclosure of capital requirements and how capital is managed would not provide useful information or distorts a financial statement user's understanding of an entity's capital resources, the entity shall disclose separate information for each capital requirement to which the entity is subject.

Discussion questions	
9.	Do you believe that regulatory funding arrangements should be disclosed?
10.	If so, what information should be disclosed?

Restrictions

19. Some believe that additional disclosures on the restrictions on the defined benefit plan assets and liabilities would be useful to help users assess risks arising from defined benefit plans. Examples of such disclosures are those proposed in Exposure Draft 10 *Consolidated Financial Statements* (ED 10). These disclosures were proposed to enable users to understand the nature and financial effect of restrictions of asset and liabilities held by subsidiaries. The proposed disclosures are:

Restrictions on consolidated assets and liabilities (paragraph 48(c))

B1 To meet the objective in paragraph 48(c), a reporting entity shall disclose the nature of restrictions that are a consequence of assets and liabilities being held by subsidiaries, including:

(a) the extent to which non-controlling interests can restrict the activities of subsidiaries.

(b) legal, contractual and regulatory restrictions, such as:

(i) those that restrict the ability of subsidiaries to transfer cash to entities within the group; and

(ii) guarantees that may restrict dividends being paid to entities within the group.

(c) the carrying amount in the consolidated financial statements of the assets and liabilities to which those restrictions apply.

20. Some believe that the disclosures on the restrictions on defined benefit plan assets and liabilities are more useful than the regulatory disclosures discussed earlier. They contend the risks targeted in those regulatory disclosures are similar to the risks arising from restrictions on the defined plan assets and liabilities. Also, in some jurisdictions, restrictions on the defined benefit plans and liabilities arise from agreements between the trustees and entities and not regulatory arrangements. Therefore, a more general disclosure requirement on restrictions on defined plans assets and liabilities may be applicable to more jurisdictions.

Discussion questions
11. Should disclosures on restrictions of defined benefit plan assets and liabilities be disclosed?
12. If so, what types of information should be required?

Asset and liability matching

21. Some contend that information on the entity's asset-liability management would assist users in assessing the entity's likely future contributions in meeting future payments. Therefore, they recommend qualitative disclosures on an entity's objectives, policies and procedures for asset-liability management. Others suggest also requiring quantitative type disclosures (eg contractual maturity analyses for post-employment benefit assets and liability) similar. A few suggest similar disclosures to the liquidity risk disclosures in IFRS 7 *Financial Instruments: Disclosures* as follows:

Liquidity risk

39 An entity shall disclose:

(a) a maturity analysis for non-derivative financial liabilities (including issued financial guarantee contracts) that shows the remaining contractual maturities.

(b) a maturity analysis for derivative financial liabilities. The maturity analysis shall include the remaining contractual maturities for those derivative financial liabilities for which contractual maturities are essential for an understanding of the timing of the cash flows (see paragraph B11B).

(c) a description of how it manages the liquidity risk inherent in (a) and (b).

…

B11B Paragraph 39(b) requires an entity to disclose a quantitative maturity analysis for derivative financial liabilities that shows remaining contractual maturities if the contractual maturities are essential for an understanding of the timing of the cash flows. For example, this would be the case for:

(a) an interest rate swap with a remaining maturity of five years in a cash flow hedge of a variable rate financial asset or liability.

(b) all loan commitments.

…

B11E Paragraph 39(c) requires an entity to describe how it manages the liquidity risk inherent in the items disclosed in the quantitative disclosures required in paragraph 39(a) and (b). An entity shall disclose a maturity analysis of financial assets it holds for managing liquidity risk (eg financial assets that are readily saleable or expected to generate cash inflows to meet cash outflows on financial liabilities), if that information is necessary to enable users of its financial statements to evaluate the nature and extent of liquidity risk.

Discussion questions

13. Do you think that information on the entity's asset-liability management should be required?

14. If so, what type(s) of information?

Other risk disclosures

22. Some believe that the disclosures proposed in ED 10 on the nature and risks associated with an entity's involvement with structured entities that are not controlled and hence, not consolidated are also useful for defined benefit plans. Those disclosures are:

> ***Involvement with unconsolidated structured entities and associated risks (paragraph 48(d))***
>
> B2 To achieve the disclosure objective in paragraph 48(d), a reporting entity shall disclose information that enables users of its financial statements to evaluate:
>
> (a) the nature and extent of the reporting entity's involvement with structured entities that it does not control;
>
> (b) the nature and extent of, and changes in, the market risk (interest rate, prepayment, currency and other price risk), credit risk and liquidity risk from the reporting entity's involvement with structured entities that it does not control. This exposure may arise from both contractual and non-contractual commitments, and from past and present activities.
>
> B3 If obtaining any of the information for the disclosures required by this [draft] IFRS is impracticable, the reporting entity shall disclose why it is impracticable to obtain the information, and how it manages its exposure to risk from its involvement with unconsolidated structured entities for which it is impracticable to obtain the information.

23. The disclosures in paragraph B2(b) are to similar to the disclosures recommended in IFRS 7 *Financial Instruments: Disclosures* because it is likely that the majority, if not all, unconsolidated structured entities will be in the form of financial instruments.

Discussion questions
15. Should there be disclosures on the risks arising from a defined benefit plan similar to the risk disclosures proposed for unconsolidated structured entities?
16. If so, what types of information should be required?