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International
Accounting Standards
Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**March 2009, London**
Project:	**Post-employment Benefits**
Subject:	**Additional issues raised by comment letters - Accounting for plans with risk sharing or conditional indexation features (Agenda paper 8G)**

Purpose of this paper and staff recommendation

1. The purpose of this paper is to examine the accounting for plans with risk sharing or conditional indexation features in accordance with IAS 19, and to recommend whether the current requirements should be clarified.

2. **In a paragraph 22, the staff recommends the Board amend IAS 19 to clarify that conditional indexation and risk sharing features in a plan should be reflected in the measurement of the obligation.**

The issue

3. Some post-employment benefit plans include features where the risks are shared between the parties involved, i.e. employer, employees, former employees and retirees. These plans allow the benefits of a surplus or the costs of a deficit to be allocated between the various parties. For example, the deficit may partly be allocated to the employer through additional required contributions, and partly

allocated to members through a reduction in benefits. These features are referred to as "risk-sharing".

4. Other post-employment plans include promises that are conditionally indexed to salary increases. Conditional indexation refers to a plan's requirement to increase benefits for wage or price inflation based on some criteria. This paper regards such conditional indexation features as similar to risk-sharing features because both result in the allocation of the effects of risk to more than one party.

5. The issues identified by the comment letters are:

   (a) IAS 19 makes no distinction between an employer that bears all the actuarial and investment risk in a plan, and an employer that shares these risks with other stakeholders. Both are classified as defined benefit plans.

   (b) There is no guidance as to how these conditional terms should be applied in the measurement of the defined benefit obligation.

6. Some respondents have suggested the following possible solutions:

   (a) account for plans that meet certain conditions as defined contribution plans, supplemented with additional disclosures that would enable the user to evaluate the extent of risks arising from such plans. This is discussed in paragraphs 11-16.

   (b) provide further guidance to clarify how risk sharing arrangements should be taken into account when measuring the defined benefit obligation. This is discussed in paragraphs 17-22.

Staff analysis

Similar issues considered by the IFRIC

7. The IFRIC has already considered and rejected similar issues that related to:

   (a) employee contributions and how to account for a pension plan in which the cost of providing the benefits is shared between the employees and the employer (November 2007); and

   (b) pension promises based on performance targets (January 2008).

8. In November 2007, the IFRIC considered whether to provide guidance on how to account for a pension plan in which the cost of providing the benefits is shared between the employees and the employer. The IFRIC decided to reject the issue for the following reasons:

> "the IFRIC noted that paragraph 85 of IAS 19 states that 'If the formal terms of a plan (or a constructive obligation that goes beyond those terms) require an entity to change benefits in future periods, the measurement of the obligation reflects those changes.' Therefore, the IFRIC noted that:
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> - if the terms of a defined benefit plan include surplus-sharing provisions, the employer's obligation to use any surplus in the plan for the benefit of plan participants (eg adjusting participants' benefits) should be considered when measuring its obligation.
> - if the terms of a defined benefit plan include cost-sharing provisions, the requirement for employees to make contributions to reduce or eliminate an existing deficit should be considered when measuring the employer's obligation."

9. In January 2008, the IFRIC received a request to clarify the measurement of the defined benefit obligation when pension promises are based on achieving specific performance targets. Performance targets may relate to various forms of pension promises ranging from additional pensionable earnings from performance bonuses to more complex arrangements relating to additional sponsor contributions or years of deemed service. The issue is how defined benefit plans with such features should be accounted for in accordance with IAS 19. The IFRIC decided to reject the issue for the following reasons:

> "The IFRIC noted that paragraph 73 of IAS 19 states that 'Actuarial assumptions are an entity's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits.' Performance targets are variables that will affect the ultimate cost of providing the post-employment benefits. They should therefore be included in the determination of the benefit."

10. Notwithstanding the above, the responses to the discussion paper indicate that there still appears to be diversity in practice as to how the requirements of IAS 19 apply to arrangements with risk sharing and conditional indexation features.

Accordingly, the staff thinks that it would be helpful if the Board clarifies the application of IAS 19 to plans with these features.

Accounting for plans with risk sharing arrangements as defined contribution

11. Paragraph 25 of IAS 19 distinguishes between *Defined Contribution Plans* as follows:

> Post-employment benefit plans are classified as either defined contribution plans or defined benefit plans, depending on the economic substance of the plan as derived from its principal terms and conditions. Under defined contribution plans:
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> (a) the entity's legal or constructive obligation is limited to the amount that it agrees to contribute to the fund. Thus, the amount of the post-employment benefits received by the employee is determined by the amount of contributions paid by an entity (and perhaps also the employee) to a post-employment benefit plan or to an insurance company, together with investment returns arising from the contributions; and
>
> (b) in consequence, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall on the employee.

12. Some respondents have suggested that plans with risk sharing features should be accounted for as defined contribution plans if they meet certain conditions, such as all or some of the following:

    a. The plan is administered by an independent entity

    b. Any curtailment, settlement or amendment must be approved by the governing body of the plan

    c. The governing body must decide how to allocate the surplus or deficit among the stakeholders in the case of termination, unwinding or when a legal or statutory minimum funding level is present

    d. The plan formula is based on a current or career average and indexation will only be granted if the plan holds sufficient assets

    e. The plan should be mutually funded and the funding level should be agreed by both parties.

13. Paragraph 25 above is clear that to meet the definition of a defined contribution plan the employers legal and constructive obligation must be limited to the amount that it agrees to be contributed to the fund.

14. Supporters of applying defined contribution accounting to the above plans argue that the actuarial and investment risks rest *predominantly* upon the current and former employees and retirees. Generally these types of plans are able to allocate the effects of these risks to members by taking some or all of the following steps:

    a. Foregoing the indexation of accrued pension entitlements because of contractual arrangements that indexation can only be granted if the fund has sufficient assets.

    b. A reduction of pension entitlements earned by active employees in the current service period.

    c. A reduction of accrued pension entitlements

15. The plan is also able to allocate the risks to the employer by raising the required contribution rate. However, some argue the conditional indexation limits the amount of risk borne by the employer in this respect.

16. The staff does not agree that plans with risk sharing features should be treated as defined contribution plans. The staff notes that, as set out in paragraph 15, the employer maintains some residual risk and therefore their legal and constructive obligation is not limited to the contributions paid into the plan.

Additional guidance on the measurement of risk sharing arrangements

17. Para 85 of IAS 19 states:

> If the formal terms of a plan (or a constructive obligation that goes beyond those terms) require an entity to change benefits in future periods, the measurement of the obligation reflects those changes. This is the case when, for example:
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> (a) the entity has a past history of increasing benefits, for example, to mitigate the effects of inflation, and there is no indication that this practice will change in the future; or
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> (b) actuarial gains have already been recognised in the financial statements and the entity is obliged, by either the formal terms of a plan (or a constructive obligation

that goes beyond those terms) or legislation, to use any
surplus in the plan for the benefit of plan participants
(see paragraph 98(c)).

18. We note that paragraph 85(b) is already clear that the effects of surpluses should be reflected in the measurement of the obligation to the extent that surpluses are required to be shared between the employer and employees. It is less clear on the effect when deficits are required to be shared, or benefits are conditional to some extent on there being sufficient plan assets to fund them.

19. Some constituents believe that the measurement requirements in paragraph 85 imply that an entity's past history of granting conditional indexation increases should be considered to create a constructive obligation for similar increases in the future. In other words, the indexation increases should be treated as unconditional and therefore no probability adjustment is allowed for the event that future increases might be lower than past increases.

20. Such an approach would mean that IAS 19 makes no distinction between a plan where the employer is solely responsible for the actuarial and investment risk and one where the employer shares those risks with other stakeholders.

21. The staff agrees that IAS 19 requires the obligation to be based on the terms of the plan and any constructive obligation. But the staff note that this means that if the terms of the plan includes conditional benefits, and those conditional benefits really are conditional, then the measurement of the obligation should be based on a best estimate that includes the conditionality. So the best estimate should allow for the fact that future increases are expected to be lower than past increases, and, if the benefits depend on the level of funding, include the effect of any deficit in the plan.

22. Based on the above, the staff recommends the Board amend IAS 19 to clarify that conditional indexation and risk sharing features in a plan should be reflected in the measurement of the obligation.