Project **Post-employment benefits**

Topic **Risk sharing features**

Objective

1. This paper provides:
   - (a) Background, including an overview of the proposals in the exposure draft *Defined Benefit Plans* (the ED) relating to the accounting for risk sharing features (paragraphs 3 - 8).
   - (b) an overview of the responses to the ED (paragraphs 9 –18).
   - (c) a staff analysis and recommendation (paragraphs 19 – 48).
2. In summary, the staff recommends that the Board:
   - (a) clarify that, for a plan to be classified as a defined benefit plan, a benefit formula needs to give rise to a legal or constructive obligation that may require the employer to pay additional contributions as a result of current or past service;
   - (b) provide no further guidance for determining whether an input into the calculation of the defined benefit obligation defines part of the terms of the benefit, or is part of the actuarial assumptions;
   - (c) clarify that the benefit to be attributed in accordance with paragraph 67 is the benefit net of the effect of the employee contributions;
   - (d) confirm the proposal that the effect of employee contributions should be deducted in determining the defined benefit obligation but withdraw

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

the proposal that the effect of employee contributions should be presented as a reduction in service cost;

(e) clarify that the assumptions used to estimate conditional indexation or changes in benefits should:

  (i) be reflected in the measurement of the obligation regardless of whether the indexation or changes in benefits are automatic or are subject to a decision by the employer, by the employee, or by a third party such as trustees or administrators of the plan; and

  (ii) be mutually compatible with the other assumptions used to determine the defined benefit obligation; and

(f) clarify that limits on the legal and constructive obligation to pay additional contributions should be included in the calculation of the defined benefit obligation.

Background

3. Some defined benefit plans include features that share the benefits of a surplus or the cost of a deficit between the employer and plan participants. Similarly, some defined benefit plans provide benefits that are conditional to some extent on there being sufficient assets in the plan to fund them. Such features share risk between the entity and plan participants.

4. The Board has been informed that practice varies on how the requirements of IAS 19 apply to arrangements with risk-sharing features, such as benefits that are conditional on asset returns or other criteria and employee contributions.

5. Some have expressed the view that IAS 19 does not address plans with such features because IAS 19 makes no distinction between an employer that bears all the actuarial and investment risk in a plan, and an employer that reduces these risks by sharing them with other stakeholders. Both are classified as defined benefit plans. They also state that the Board should provide guidance on how entities should account for risk-sharing or conditional indexation features.

6. IAS 19 defines any plan that exposes the employer to risk as a defined benefit plan. IAS 19 also requires that the defined benefit obligation is measured using the best estimate of the ultimate cost of providing that benefit. The Basis for Conclusions on the ED expressed the Board's view that risk-sharing and conditional indexation features affect that cost.

7. Accordingly, the ED proposed to clarify that risk-sharing and conditional indexation features should be incorporated in the determination of the best estimate of the defined benefit obligation. The ED also proposed to clarify the treatment of employee contributions in the light of a question rejected by the IFRIC in November 2007 – Treatment of employee contributions.

8. The ED included the following proposed amendments:

> 64A Contributions by employees to the ongoing cost of the plan reduce the amount of the current service cost recognised as an expense by the entity. The present value of contributions that will be receivable from employees in respect of current service cost or past service cost are included in the determination of the defined benefit obligation. The measurement of the defined benefit obligation includes the effect of any requirement for employees to reduce or eliminate an existing deficit.
>
> 85 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 if ~~when~~, for example:
>
> …
>
> (c) benefits vary in response to a performance target or other criteria. For example, the terms of the plan may state that it will pay reduced benefits or require additional contributions from employees if the plan assets are insufficient. The measurement of the obligation reflects the best estimate of the effect of the performance target or other criteria.

Responses to the ED

9. Question 13 (g) of the ED asked:

> **Question 13**
>
> The exposure draft also proposes to amend IAS 19 as summarised below:
>
> …
>
> (g) Risk-sharing and conditional indexation features shall be considered in determining the best estimate of the defined benefit obligation. (Paragraphs 64A, 85(c) and BC92–BC96) (Paragraphs 7, 73(b), BC82 and BC83)
>
> …
>
> Do you agree with the proposed amendments? Why or why not? If not, what alternative(s) do you propose and why?

10. Most respondents agreed that the Board should clarify that risk sharing features should be taken into account in measuring the defined benefit obligation.

11. Some respondents disagreed with this clarification, preferring that the Board address risk-sharing features as part of a fundamental review of measurement. These respondents expressed doubts about whether the proposals could adequately address risk sharing features on the basis of the existing defined benefit/defined contribution distinction and on the basis of the existing measurement model for defined benefit plans. These respondents would prefer the Board to address the classification and measurement fundamentally in order to address the whole spectrum of plans from defined contribution to defined benefit (including contribution based promises).

12. Some indicated that the existing requirements of IAS 19 are already applied in accordance with the proposed clarification. For example, they indicated that the effect of conditional indexation that depends on investment returns would be determined using the assumption setting process to set a reasonable best estimate.

Level of clarification

13. Of the respondents that agreed that the Board should address the accounting for risk-sharing as part of the current project, some agreed that level of clarification proposed was adequate, while others believed there was too little or too much guidance.

14. The respondents that agreed with the level of clarification proposed suggested that any further guidance should wait until a fundamental review of measurement. For these respondents, clarifying that these features should be considered in determining the ultimate cost is sufficient for this stage of the project. A few respondents suggested that freedom should be given to an entity to present its arrangements in the way that most appropriately reflects the circumstances of its plan. However, other respondents were concerned that the proposals as drafted would be difficult to implement and could lead to diversity in practice. These respondents requested further guidance or illustrative examples to demonstrate how the Board intends the proposals to be applied.

Jurisdiction-specific comments

Netherlands

15. While instances of plans with some risk-sharing features can be found in most jurisdictions, risk sharing features are a common element of most plans in the Netherlands, which typically include many different types of risk sharing features in a single plan. Hence, respondents from the Netherlands paid particular attention to the proposed requirements related to risk sharing and typically made the following comments:

    (a) The current definition of a defined benefit plan may include plans that are economically defined contribution plans in nature but, due to the existence of a benefit formula in the terms of the plan, are classified as defined benefit even though the entity's legal and constructive obligation is limited to contributions for current service. This is because the criteria in paragraph 26 of IAS 19 are not decisive if both

the benefits and the contributions are defined (eg the benefits are based on a target level of pension (the plan benefit formula) and the contributions are based on a percentage of current salary). Respondents suggested that this could be addressed by adding to Paragraph 25 of IAS 19 (or by adding to the examples provided in paragraph 26 of IAS 19):

> The calculation of the periodic contribution payable may be based on a target or aspired level of post-employment benefits. When the entity has no further legal or constructive obligation other than to pay the agreed contributions for any service period and the participating (former) employees are properly informed about this limitation of the entity's obligations such a plan classifies as a defined contribution plan.

(b) The proposed amendments in the ED are drafted too narrowly and leave no room to recognize the relationship, mandated by law, between the employer, the fund and the participants. Even if the amendments in the ED are finalised, they will only address some of the risk sharing features that exist. Different discount rates, the possibility under law to limit the obligations of the employer, and limits on additional contributions by the employer and the possibility to reduce the rights of members and beneficiaries if the pension fund is not sufficiently funded, all may lead to a measure of liabilities exceeding the economic obligation.

(c) Paragraph 64A as drafted requires the inclusion in the measurement of the obligation the effect of any requirement for employees to reduce or eliminate an existing deficit. However, there is not always a direct relationship between future employee contributions and the IAS 19 deficit as the contribution rates are based on funding calculations, not the IAS 19 deficit. Employees cannot usually be levied for additional contributions for an existing deficit. As a result many in the Netherlands concluded from the text as drafted that future contributions by employees must effectively be ignored for IAS 19 measurement

purposes. Ignoring future contributions by employees would be inconsistent with taking future salary increases into account under the projected unit credit method in measuring the defined benefit obligation. This is because a portion of future employee contributions would be connected with the same salary increases included in the defined benefit obligation. The text in paragraphs BC95 and BC96 of the Basis for Conclusions (reproduced as paragraphs 6 and 7 of this paper) is clearer on this issue than the proposed text in the ED. The above issue could be resolved by adding to the end of paragraph 64A (or somewhere else) the following text:

> The measurement of the obligation includes the effect of any requirement for employees to reduce or eliminate an existing deficit. The measurement of the obligation excludes any other element that is not funded by the employer.

(d) If under a pension arrangement there is a past history of granting conditional indexation, then, in general, based on paragraph 85(a), the measurement of the benefit obligation has to reflect any anticipated future indexation. However, in the Netherlands, the granting of conditional indexation is usually contingent on the realization of future returns on plan assets. These respondents noted that the strict separation of the measurement of assets and liabilities under IAS 19 results in a mismatch: the conditional indexation is included in the measurement of the defined benefit obligation, but it only becomes a liability when future surplus returns are realized. As a consequence, at any balance sheet date the liability increase in respect of future conditional indexation is, in the views of these respondents, in reality not a liability, since, absent proof of surplus future returns, fund management cannot take the decision to grant such conditional indexation. To assume, as IAS 19 does, that the valuation of assets and liabilities are disconnected in this respect is ignoring reality, which is shown by the above. In this

situation, there is general consensus in the Netherlands that the net pension liability is clearly overstated from an employer's perspective.

(e) Many hybrid plans vary the annual contributions required between the boundary levels agreed in the administration agreement, thereby limiting the entity's exposure to actuarial and investment risk. Beyond the agreed boundaries in contribution levels, those risks are born by the participants in the scheme. If a pension plan is classified as a defined benefit plan such a limit on contributions should be included in the assumptions underlying the measurement of the pension obligation. The resulting assumption would ensure that any liability recognized under IAS 19 would never exceed the best estimate of the future cash outflows related to current and prior period from the perspective of the entity. The current proposed text in paragraph 85c is not clear on this specific matter because, as it reads now, an entity should be required to change benefits according to the terms of the plan while in the Dutch environment the discretion to change benefits is with pension fund management (ie the pension fund has the ability to change benefits, not the entity). The above issue could be resolved by adding after paragraph 85(c) of the ED the following:

> (d) the formal terms of the plan limit the legal and constructive obligation to pay additional contributions to cover a shortfall in the fund's assets.

Switzerland

16. In Switzerland, by law an entity cannot be required to cover more than 50% of any deficit. There is also a history that employees have indeed contributed 50% of the funds necessary to cover past deficits (typically either in the form of future contributions deducted from future salary payments or by receiving lower benefits as a result of lower interest credits to their pension accounts). If the plan has a significant deficit, the trustees of the plan must take appropriate actions to make good the shortfall in the medium term, including reducing benefits for active employees of the plan (but not below regulatory required

minimums) and requiring increased contributions for both the employer and employees (of which at least 50% must be paid by the employer). The entity's sole legal responsibility relating to the Swiss pension plan is to fund contributions at a level defined in the plan rules and pursuant to Swiss regulatory requirements. However, because of the guarantee that pension funds must be fully funded on a medium term basis, entities may be hit by the requirement to pay additional contributions as described above.

17. Respondents from Switzerland asked whether the amendments would mean that the defined benefit obligation accounted for according to IAS 19 in the entity's accounts would only ever be 50 % of the deficit, and whether this change was intended. Based on the proposal in the ED, they believe that there is a significant risk of future variance in practice as the wording of the relevant paragraphs allows for a wide range of interpretations. Therefore they propose to expand the guidance in IAS 19, e.g. by providing an illustrative example based on a situation as outlined above, thereby clarifying that such changes are indeed intended. Alternatively, if allowing such changes in current practice is not what the Board intended, they propose to delete the proposed paragraphs 64A and 85(c) and address the issue in the context of a more fundamental review of accounting for pensions. They suggest that this would leave the situation as unsatisfactory as it presently is, but it would at least not add new inconsistencies in practice.

Requests for further clarification

18. Many respondents requested further clarification in the following areas:

    (a) *Employee contributions* – In addition to the views in paragraph 15(c) above, many respondents were unsure how to interpret and apply the proposals addressing employee contributions. In particular, many were unsure how to distinguish between contributions for past and current service and contributions for future service. Some respondents also suggested that including future employee contributions that reduce an existing deficit would not result in any change to the net deficit or

surplus as receipt of the contributions would increase the defined benefit obligation and the plan assets by the same amount.

(b) *Projecting future funding status and asset returns* – Some respondents read paragraph 85(c) as implying that an entity is required to project the future funding position (on the basis used to set contribution rates) and then establish the impact that the funding level might have on future benefits and contribution requirements. These respondents believe that projecting the funding position would involve a significant amount of additional work and that in most regions it would be very difficult to establish a suitable adjustment to the liabilities to reflect the effect of risk-sharing features based on the funding position. Some suggested that the effect of risk-sharing features based on the funding position on the liability should be on the basis of the current position of the plan at the reporting period.

(c) *Funding basis vs accounting basis* – Some respondents were unsure whether the basis for determining the effect of risk-sharing should be the funding assumptions or the IAS 19 assumptions. For example it may be difficult to determine the component of future employee contributions that relate to an existing deficit if the contributions are based on funding rules different to the measurement and recognition requirements of IAS 19.

(d) *Actuarial gain or loss vs past service cost* – Some respondents were unsure how to distinguish between an assumption and the terms of the benefit. Changes in an assumption should reflect the current best estimate and are remeasurements, whereas changes to the terms of the benefit are recognized when they occur and are past service cost. The classification of an input into the defined benefit obligation as either a term of the benefit or an assumption will affect the timing of recognition and presentation of changes in that input. For example, this would be an issue in a situation where the assets of a pension fund are

insufficient and the entity foresees that the board of the fund has no realistic alternative other than to reduce the benefits.

(e) *Sharing some risks* – Some respondents noted that only some risks are shared in particular plans. For example, in plans offered by life insurance companies in Norway, parts of the mortality and disability risk might be shared between participating employers. These plans have a risk result each year related to mortality and disability. Employers with low mortality or high disability get funds transferred from the risk result. In such plans the relevant estimates are the expected mortality and disability rates of the plan members of all employers participating in the risk sharing plan within the insurance company.

(f) *Sharing risks with other parties* – Some respondents noted that risks are shared not only with employees but also with other parties. For example, respondents noted that particular plans in Japan have risk-sharing arrangements with the government whereby the government has the final responsibility to take the financing and actuarial risk and the plans have the final responsibility to take the investment risk.

(g) *Inconsistency with disaggregation* – One respondent stated that a net interest approach (for presenting changes in employee benefit assets and liabilities) introduces an inconsistency if benefits depend on the return on plan assets. In this case, the respondent interpreted the proposals as requiring an entity to calculate service cost on the basis that pension increases would result from asset returns that meet expectations, whereas the related asset return would be presented in remeasurements.

Staff analysis and recommendation

19. The Board addressed the accounting for risk sharing features in the ED on the basis that:

(a) they could be addressed expeditiously.

(b) this issue does not require a fundamental review of defined benefit obligation measurement.

(c) addressing this issue would lead to a worthwhile improvement in the reporting of defined benefit plans.

20. This section considers:

(a) the distinction between defined benefit plans and defined contribution plans (paragraphs 21- 23); and

(b) accounting for risk sharing features in a defined benefit plan including, conditional indexation, changing benefits and employee contributions (paragraphs 24 - 48).

Distinction between defined benefit plans and defined contribution plans

21. Some respondents expressed a concern that the description of a defined benefit plan in paragraph 26 of IAS 19 includes plans with a benefit formula, but does not require the benefit formula to affect the level of payments by the employer, and this has led to defined benefit classification for some plans that have characteristics of defined contribution plans. This is because some defined contribution plans have a benefit formula that determines the benefits to be paid if there are sufficient plan assets, but does not require the employer to pay additional contributions if there are insufficient plan assets to pay out benefits in accordance with the benefit formula. In effect, the benefit payments are based on the lower of the benefit formula and the plan assets available. The following example is intended to illustrate the issue, and not intended to illustrate the recommendation.

> *Example 1*
>
> An entity provides a post-employment benefit plan through a legally separate fund. The plan benefit formula is based on a percentage of pensionable salary earned in each year of service.

> Under the terms of the plan the entity's sole obligation is to pay the agreed contributions for the service period to the fund. Contributions are set at a level that is intended to cover the cost of providing the benefits earned for the related service period.
>
> In case of a deficit, the fund cannot charge additional contributions to the entity. If there are insufficient assets or an inability to recover from a deficit situation, the only remedy of the fund is to reduce the benefits of the participants in order to restore its solvency balance. There is no right, either legal or constructive, to revert to the entity in order to avoid the reduction of benefits. Also in case of a partial or full settlement of the plan the entity is not liable for any remaining deficit, nor does the entity have any right to a refund if the plan has a surplus.
>
> The participants in the plan are fully informed about the fund's inability to charge additional contributions to the entity and the remedies available to the fund in the case of a deficit.

22. The plans referred to in paragraph 21 are the inverse of the 'higher of' plans considered in the Board's discussion paper *Preliminary Views on Amendments to IAS 19*. In that discussion paper the Board noted that the projected unit credit method uses point estimates to calculate a best estimate of the liability and ignores the value of the option to obtain the higher benefit. Ignoring the value of any option underestimates the liability. These defined contribution plans are also similar to discretionary participation features (DPF), as defined in IFRS 4 *Insurance Contracts*, that provide additional benefits in addition to the guaranteed minimum benefits. Under the proposals in the exposure draft *Insurance Contracts*, the additional cash flows are included in the measurement of a participating liability on an expected value basis. Those cash flows would be discounted at a rate appropriate for the underlying assets, if they vary one for one with the assets, and using option-pricing techniques if the pay-offs vary asymmetrically with the asset cash flows.

23. The Board could address the concern described in paragraph 21 by clarifying that the existence of a benefit formula does not, by itself, define a defined benefit plan, but rather there needs to be a link between the benefit formula and contributions such that there is a legal or constructive obligation to contribute further amounts to meet the benefits in the benefit formula.

Question 1
Does the Board agree to clarify that, for a plan to be classified as a defined benefit plan, a benefit formula needs to give rise to a legal or constructive obligation that may require the employer to pay additional contributions as a result of current or past service?

Accounting for risk sharing features in a defined benefit plan

24. This section considers:

    (a) Terms of the benefit promise vs assumptions (paragraphs 25 - 28)

    (b) Employee contributions (paragraphs 29- 35)

    (c) Conditional benefits (paragraphs 36 - 40)

    (d) Limits on employer contributions (paragraphs 42 - 44)

    (e) Sharing risks with entities other than employees (paragraphs 45 - 48)

Term of the benefit promise vs assumption

25. Determining whether an input into the defined benefit obligation is part of the benefit formula or an actuarial assumption will affect the recognition and presentation of changes in that input. As noted in Agenda Paper 11A discussed in December 2010, it is not often clear whether a given input is an assumption or defines part of the benefit promise.

26. Past service cost arises when the benefits that were promised to employees are amended. Changes in inputs that define part of the benefit promise are a past service cost and are:

    (a) recognised when the plan amendment occurs; and

    (b) presented together with current service cost.

27. Actuarial gains and losses arise when actual outcomes are different to the actuarial assumptions previously estimated when measuring the defined benefit obligation. With actuarial gains and losses the original benefit promise is not changed, but the effect of that benefit promise depends on the ultimate outcome of some future event. In measuring the defined benefit obligation, an employer

makes estimates of the future outcome. IAS 19 uses the term 'assumptions' to describe those estimates. Changes in inputs that are an actuarial assumption are actuarial gains and losses and are:

(a) recognised when there is a change in the best estimate of the assumption; and

(b) presented together with remeasurements.

28. The staff thinks that determining whether an input into the calculation of the defined benefit obligation defines part of the benefit promise, or is part of the actuarial assumptions, requires judgement, particularly with regard to the constructive obligation paragraphs 52 and 53 of IAS 19. Consequently, the staff does not think that further clarification should be provided. Paragraph 86 notes that:

> Actuarial assumptions do not reflect future benefit changes that are not set out in the formal terms of the plan (or a constructive obligation) at the end of the reporting period. Such changes will result in:
>
> (a) past service cost, to the extent that they change benefits for service before the change; and
>
> (b) current service cost for periods after the change, to the extent that they change benefits for service after the change.

Employee contributions

29. Most respondents supported the intention to clarify how employee contributions should be taken into account, however there were concerns about how the proposed amendments would be applied, particularly on how employee contributions could be allocated to periods of service and how to account for changes in the rates of employee contributions.

30. Paragraph 91 of IAS 19 already describes how employee contributions should be accounted for medical costs. Paragraph 91 states:

> Some post-employment health care plans require employees to contribute to the medical costs covered by the plan. Estimates of future medical costs take account of

> any such contributions, based on the terms of the plan at the end of the reporting period (or based on any constructive obligation that goes beyond those terms). Changes in those employee contributions result in past service cost or, where applicable, curtailments. The cost of meeting claims may be reduced by benefits from state or other medical providers (see paragraphs 83(c) and 87).

31. The requirements in paragraph 91 could be made to apply more explicitly to all benefits. However, the discussion in paragraphs 25 – 28 above on determining whether an input is a formal term of the plan or an actuarial assumption applies to determining the effect of employee contributions and changes to those contributions, and therefore could result in past service cost or actuarial gains or losses. For example, take a benefit that promises to pay CU1,000 in ten years and for which the employer and employee contribute 50% each. Ignoring discounting, the ultimate cost of the benefit to the employer will be CU500 and CU50 would be attributed to each year of service in accordance with paragraph 69. If the proportion of contributions between the employee and employer changes, an entity would have to determine whether the result of the change is a past service cost or an actuarial gain or loss. The staff thinks that paragraph 91 should be clarified to reflect that the changes in employee contributions could also result in actuarial gains or losses.

32. The staff thinks the contributions required by the employees could be considered a negative benefit and therefore, the attribution of the contributions should be determined in accordance with paragraph 67, in accordance with the benefit formula, or on a straight line basis (ie the back-end loading test and attribution in paragraph 67 should be based on the net benefit). Clarifying this should address concerns respondents have about determining the component of a contribution that relates to current and prior year service. Attributing the employee contributions on the same basis as the benefits will also address the concerns of those respondents who argued that the defined benefit obligation includes the cost of future increases in salaries but not the benefit of future contributions related to those salary increases.

> *Example 2*
>
> A plan promises to pay a benefit equal to 10% of final salary in ten years of which the employees contribute 40%. Assuming no discounting, and a final salary of CU10,000, the benefit would be CU1,000 and the ultimate cost of the benefit to the employer will be CU600 with CU60 attributed to each year of service on a straight line basis in accordance with paragraph 67.

33. If employee contributions to fund service cost are not linked to particular years of service, or to salaries, they should be attributed on the same basis as benefits that are not linked to particular years of service or to salaries. The staff notes that there is currently diversity in practice about how such benefits are attributed to periods of service (for example, death benefits) and proposes no further clarification at this stage of the project.

34. Not all employee contributions are payable for service. Some plans require employees to contribute to the reduction of a deficit. If a deficit results from negative returns on plan assets, or changes in the actuarial assumptions used to measure the liability, then employee contributions reducing such a deficit have the effect of reducing the loss on plan assets, or reducing actuarial losses and not reducing service cost.

> *Example 3*
>
> Extending Example 2, assume that 5 years into the arrangement the benefit accrued is CU500 and the employer and employee have contributed CU300 and CU200 respectively as required. However, the plan assets have returned a negative CU100 for the year, resulting in a deficit of CU100 (the defined benefit obligation of CU500, less plan assets of CU400). Because the employees contribute 40% to the reduction of the deficit, the defined benefit obligation is reduced by CU40 (the employees' portion of the contributions) to CU460 resulting in a net defined benefit liability of CU60 recognised by the employer. However, the other side of the accounting entry that reduces the defined benefit obligation does not reduce the service cost for the year, instead the loss on plan assets should be offset by CU40 and therefore the remeasurements component should be credited by CU40 because that is where the employer presented the loss on plan assets. Thus the entry to account for the effect of employee contributions receivable would be as follows:

Dr Defined benefit obligation	CU40	
Cr Remeasurements		CU40

And to account for the receipt of contributions would be as follows:

Dr Plan assets	CU40	
Cr Defined benefit obligation		CU40

If the deficit resulted from changes in actuarial assumptions (such as a change in estimate of the final salary or a change in mortality assumptions), the effect of the employee contributions would offset the actuarial losses.

35. In other words, the staff think that the effect of employee contributions should be disaggregated between the components of defined benefit cost. This would reflect that in some cases, employees are sharing not only the cost of the current year's service, but also the actuarial and investment risk. However requiring the disaggregation of the effect of employee contributions to the components of defined benefit cost will be difficult to implement. Paragraph 64A of the ED proposed that contributions by employees to the ongoing costs of the plan reduce the amount of the current service cost. Because this is not always the case, the staff recommends that paragraph 64A should be amended to refer only to the effect of employee contributions on the defined benefit obligation, without referring to the presentation of the effect in the statement of comprehensive income. The staff thinks that presentation of the defined benefit cost (net of any effect of employee contributions) is addressed by the general disaggregation and presentation principles for defined benefit cost.

Conditional benefits

36. Most respondents agreed with the Board's proposal for conditional benefits, however some were concerned about taking into account conditional indexation of benefits in the liability where the indexation is conditional on the assets in the plan. The concern is that the effect of a future increase in the assets is taken into account in the measurement of the liability but not in the measurement of plan

assets. Other concerns include that the requirements are drafted too narrowly: that the effect of conditional indexation is only taken into account if the terms of the plan allow an entity (and not plan management) to adjust the benefits promised.

37. The staff agree with the views that the determination of the ultimate cost of the benefits should include the best estimate of variable benefits regardless of whether the benefits are adjustable by the entity, plan management or the employees. This is similar to benefit options available to employees (such as employees having the option to take a lump sum or a pension) where a best estimate of the outcome is required. The staff think the critical factor is whether the terms of the plan require or allow the variable benefits regardless of who has the right to change the benefits, be it the entity, plan management, the employee or a another party such as the government. If the terms of the plan require or allow such a change then the measurement of the obligation should reflect an entity's best estimate of that change. The staff thinks this is consistent with the requirements of paragraphs 85 and 86 of IAS 19. The staff recommends that this is clarified in the drafting, to avoid confusion that could be caused by paragraph 85 which states 'the formal terms of the plan (or a constructive obligation that goes beyond those terms) require an entity to change benefits': some appear to interpret this as meaning that the entity is the party required to have the ability to change the benefits.

38. The concerns regarding the measurement of defined benefit obligations with conditional indexation of benefits are similar to concerns regarding the measurement of the contribution based promises that were discussed in the Board's 2008 discussion paper (ie that projecting the benefit to determine the ultimate cost and then attributing that cost to periods of service does not reflect the economics of the obligation, and overstates the obligation as the higher benefits are only payable when the asset returns are realized (ie the conditional obligation is not a liability)). The staff thinks that projecting the benefit based on current assumptions of future investment performance (or other criteria to which the benefits are indexed) is consistent with estimating the ultimate cost of

the benefit, which is the objective of the measurement of the defined benefit obligation. The Board has previously decided not to address the accounting for contribution based promises until a later stage.

39. The staff think that an entity should estimate the likely conditional indexation of benefits and pensions, based on the current funding status of the plan consistent with how financial assumptions are based. Paragraph 77 of IAS 19 requires financial assumptions to be based on market expectations at the end of the reporting period, for the period over which the obligations are expected to be settled. Therefore the assumption for conditional indexation should be an estimate at the end of the reporting period reflecting current market expectations of factors such as the future investment performance of plan assets and be mutually compatible with other actuarial assumptions (such as the discount rate used to discount the obligation).

40. Other alternatives to addressing conditional indexation could include using a different discount rate for that component of the defined benefit obligation, such as the rate of return on plan assets, or other changes to the measurement approach such as measuring the conditional indexation based on the current value of the plan assets. The staff thinks that other alternatives to addressing conditional indexation would be changing the fundamental measurement of the defined benefit obligation. The Board has previously decided that addressing the fundamental measurement of the defined benefit obligation is beyond the scope of the current project.

41. Paragraph 18(g) above reports a concern that the effect of conditional indexation on the defined benefit obligation is presented in service cost while the effect of asset returns that give rise to the conditional indexation are reflected in remeasurements. The staff agrees that a presentation mismatch arises. The employee provides services in exchange for a benefit whose ultimate amount depends on the return on plan assets (ie the benefit is a derivative based on the plan asset returns). This benefit is accumulated as service is provided, with the amount attributed to each period presented as service cost. The initial measurement of the obligation includes an estimate of the amount of conditional

indexation that will ultimately be paid, so that the entire defined benefit obligation due to service is recognized over the service period. Any changes in the defined benefit obligation resulting from changes to the initial estimate of the conditional indexation will be presented in remeasurements and the return on plan assets (less any amount included in the finance component) would also be presented in remeasurements. Because the amount of the return on plan assets included in the finance component is not based on the expected return on plan assets, the amounts included in the service cost component based on the return on plan assets would differ to the amounts included in the finance component. There will also be differences in the timing of recognition as the service cost component would be recognized over the service period, and the return on plan assets would be recognized when the fair value of the plan assets changes. The staff thinks that this is an additional source of presentation mismatch that was discussed in Agenda Paper 9D in January 2011.

Limits on contributions

42. Some respondents noted that there may be a limit on the maximum amount of contributions that an employer could be required to pay. This could be due to a funding arrangement between the entity and the plan or requirements of local laws and regulations. Such a limit would be the inverse of the minimum funding requirements addressed by IFRIC 14 *IAS 19— The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*, ie they would be maximum funding requirements. Similarly to how a minimum funding requirement limits the asset that can be recognized in the case of a surplus, the staff thinks that a maximum funding requirement would limit a liability to be recognized in the case of a deficit. Similarly to the effect of IFRIC 14, the effect of such a maximum funding requirement:

    (a) should be determined over the shorter of the expected life of the entity and the expected life of the plan.

    (b) should not be determined year by year, but in aggregate for all years.

Otherwise contributions greater than future service cost in later periods would make up any shortfall in contributions in current and prior periods. For example, the service cost may be higher than the maximum contribution amount in the current period, however if the service cost is lower than the contribution amount in subsequent years, then the effect is more of a deferral of current period contributions rather than a limit on the total contributions required.

Example 4

A plan has a maximum contribution limit of CU100 for each period of service. The expected life of the plan is 5 years, with expected service cost and contributions in each year of the next 5 years as follows:

Year	**Service Cost**	**Contribution**
1	120	100
2	120	100
3	120	100
4	60	100
5	60	100
Total	**480**	**500**

In this example, the yearly limit on contributions has not reduced the ultimate cost of the benefit.

43. Some have asked that the Board clarify that such a limit should be taken into account. The staff thinks that taking into account a maximum limit on the contributions that an entity is required to pay in the measurement of the defined benefit obligation would be consistent with the objective of determining the ultimate cost of the benefits. Clarification could be provided by including something along the lines suggested by respondents as follows:

> (d) the formal terms of the plan limit the legal and constructive obligation to pay additional contributions to cover a shortfall in the fund's assets.

44. However given that the requirements of IFRIC 14 are currently considered unclear in some cases as noted by respondents and discussed in the Board's December board meeting (Agenda Paper 11E), the staff does not recommend that further guidance is introduced for a maximum funding requirement.

Sharing risks with entities other than employees

45. Of the proposals in the ED, only the proposals regarding employee contributions apply to risk-sharing with employees specifically. It may be the case that contributions are receivable from other parties to meet the benefit obligation, however entities will need to consider whether these contributions are reimbursements as per paragraphs 104A – 104D of IAS 19 (and therefore recognized as reimbursement rights) or reductions in the defined benefit obligation.

46. The other proposals relating to risk sharing are intended to clarify further how to estimate the ultimate cost of the benefits. The ultimate cost of the benefits can be affected by risk sharing with other parties, such as other participating employers in the case of a multi-employer plan. The staff notes that this is specifically stated for medical costs in paragraph 91 of IAS 19 'The cost of meeting claims may be reduced by benefits for state or other medical providers…'. As stated in paragraph 31 above, paragraph 91 could be made to apply more explicitly to benefits other than medical benefits as well.

47. Some respondents noted that sometimes a subset of the actuarial risks (such as mortality and disability) can be shared between employers. The staff believe that the proposals require an entity to take such arrangements into account in determining the defined benefit obligation.

48. The staff do not believe the proposals were intended to be limited to specific relationships, or specific risks, and do not propose any further clarification.

Question 2
Does the Board agree: (a) to provide no further guidance for determining whether an input into the calculation of the defined benefit obligation defines part of the terms of the benefit , or is part of the actuarial assumptions? (paragraphs 25 - 28) (b) to clarify that the benefit to be attributed in accordance with paragraph 67 is the benefit net of the effect of employee contributions? (paragraphs 29 - 33) (c) to confirm the proposal that the effect of employee contributions should be deducted in determining the defined benefit obligation but withdraw the proposal that the effect of employee contributions should be presented as a reduction in service cost? (paragraphs 34 - 35) (d) to clarify that the assumptions used to estimate conditional indexation or changes in benefits should: (i) be reflected in the measurement of the obligation regardless of whether the indexation or changes in benefits are automatic or are subject to a decision by the employer, by the employee, or by a third party such as trustees or administrators of the plan? and (ii) be mutually compatible with the other assumptions used to determine the defined benefit obligation? (paragraphs 36 - 39) (e) to clarify that limits on the legal and constructive obligation to pay additional contributions should be included in the calculation of the defined benefit obligation? (paragraphs 42 - 44) If not, what does the Board propose and why?