ACTUARIAL SOCIETY OF SOUTH AFRICA

# IAS 19 Revised 2013: analysis and implications for employers and actuaries

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# Agenda

1. Review of IAS 19 before latest revision
2. Rationale for and details of latest revision
3. Illustrations based on a large Mauritian hotel group
4. General implications for employers and actuaries

# Employee benefits covered under IAS 19

- Short-term benefits (payable within a year)
- Post-employment benefits
  - Pensions and lump sum retirement benefits
  - Post-retirement medical benefits
- Other long-term benefits (paid during employment)
  - Jubilee benefits (e.g. service awards every 5 years)
  - Long service leave
- Termination benefits

# Funding cost v. accounting cost

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## FUNDING COST

- Long term approach
- Stable contributions, unless unfunded (e.g. retirement gratuities)
- Must comply with any min/max funding regulations
- Aim for sufficient assets to ensure benefit security and plan liquidity.

## ACCOUNTING COST

- Short term approach (market-driven)
- Record “true” potentially volatile cost (review each year)
- Show impact of providing benefits on employer’s financial statements
- Aim for comparability of accounts of different employers.

# Key requirements under IAS 19

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- Recognize both legal and constructive obligations to employees
- Use Projected Unit Credit as only actuarial costing method
- Demographic and financial actuarial assumptions must be "unbiased and mutually compatible"
- Financial assumptions must be based on market expectations
- Plan assets to be carried at "fair value"
- Discount rate based on market yield on high quality corporate or government bonds

# Calculation of IAS 19 P&L charge

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**Current Service Cost (Net of employee contributions)**

+

**Interest Cost**

-

**Expected Return on Plan Assets**

+/-

**Amortizations of Past Service Costs, and Actuarial Gains/Losses**

+/-

**Special Adjustments**

# Amount recognized in balance sheet

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Present Value of Defined Benefit Obligation

**-** Fair Value of Plan Assets

Funded Status

**+** Unrecognised Actuarial Gains/Losses

Unrecognised gains/losses are accumulated part of actuarial gains/losses not reflected in the P&L charge in past years

**+** Unrecognised Past Service Cost

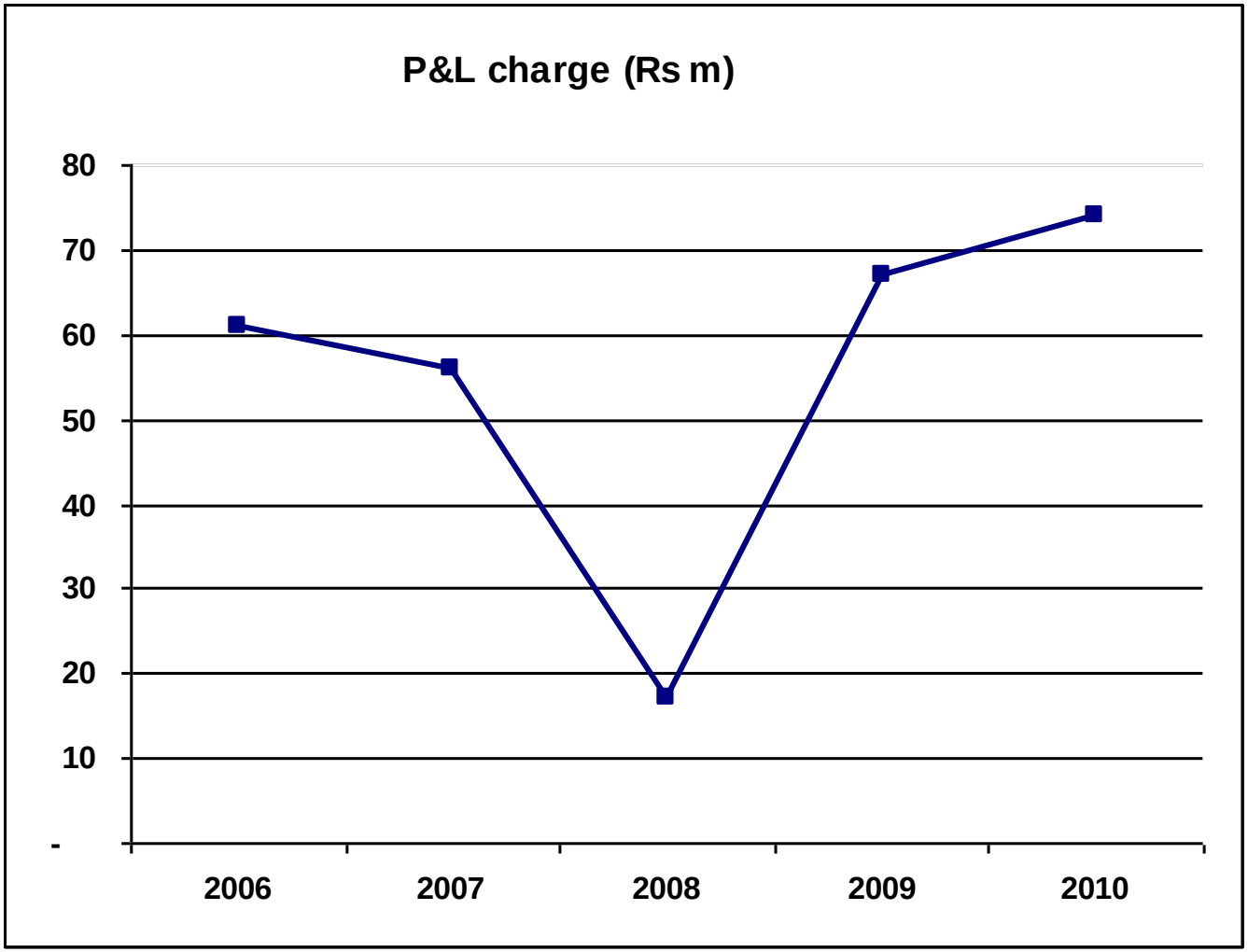
**Balance Sheet Liability/(Asset)**

# Example - IAS 19 results for NMH (Group Pension Plan) in last 5 years

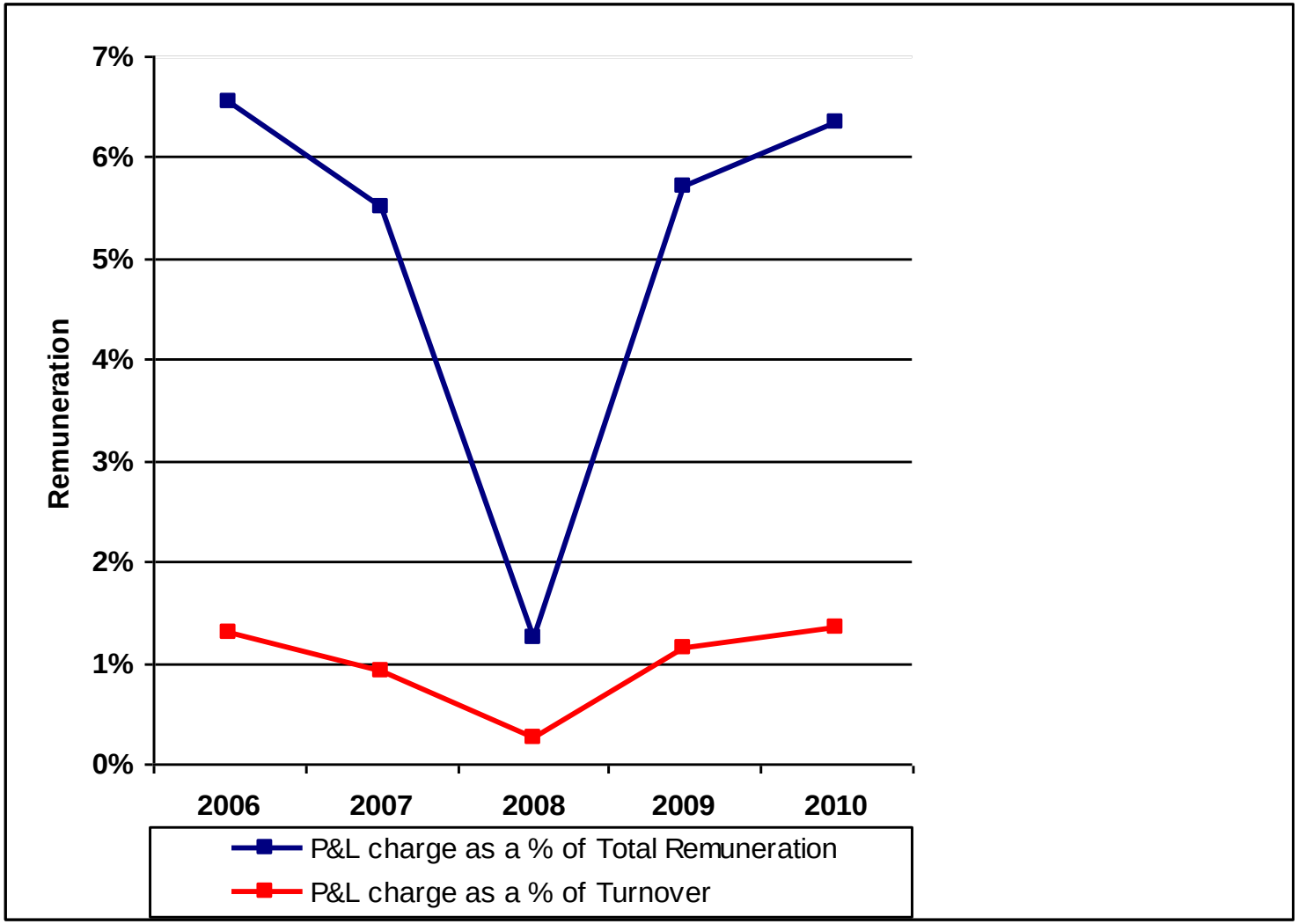
ACTUARIAL SOCIETY OF SOUTH AFRICA

| | 2010 Rs m | 2009 Rs m | 2008 Rs m | 2007 Rs m | 2006 Rs m |
|---|---|---|---|---|---|
| The amounts recognised in the Statements of financial position: | | | | | |
| Defined benefit obligation | 2,079 | 1,877 | 1,728 | 1,424 | 1,316 |
| Fair value of plan assets | (1,740) | (1,758) | (1,673) | (1,744) | (1,247) |
| | 339 | 119 | 55 | (320) | 69 |
| Unrecognised actuarial (loss)/gain | (400) | (168) | (92) | 389 | 54 |
| **Balance sheet liability/(asset)** | **(61)** | **(49)** | **(37)** | **69** | **123** |
| The amounts recognised in the Income Statements: | | | | | |
| Current service costs | 71 | 69 | 63 | 51 | 48 |
| Interest cost on benefit obligation | 190 | 175 | 154 | 138 | 103 |
| Expected return on plan assets | (187) | (178) | (187) | (136) | (93) |
| Net actuarial (gain)/loss recognised in the year | - | - | (13) | 3 | 3 |
| Net benefit expense | 74 | 66 | 17 | 56 | 61 |
| Movement in the asset recognised in the Statements of financial position: | | | | | |
| At October 1, | (49) | (37) | 70 | 123 | 159 |
| Liabilities acquired following acquisitions of subsidi | - | - | - | - | - |
| Total expense as above | 74 | 67 | 17 | 56 | 61 |
| Contributions paid | (86) | (79) | (124) | (110) | (97) |
| **At September 30,** | **(61)** | **(49)** | **(37)** | **69** | **123** |

# P&L charges in monetary terms



# P&L charges as % of remuneration or turnover



# Rationale for revising IAS 19

- Delayed recognition of gains/losses => funded status never same as balance sheet provision after adoption of IAS 19
- Can lead to asset being recognized for unfunded or underfunded plans and liability for overfunded plans
- Alternatives currently presented reduce comparability and limit usefulness to financial statement users
- Difficult to compare effects of DB plans of different companies
- Current disclosures, though expanded 5 years ago, still do not sufficiently highlight risks arising from DB plans

# IAS 19 revised in 3 main areas

| | |
|---|---|
| **Balance Sheet & Comprehensive Income** | Immediate recognition of all changes in funded status |
| **Comprehensive Income (P&L + OCI)** | Interest cost and expected return on plan assets replaced with ***net interest income/expense*** |
| **Financial Reporting & Disclosure** | Disaggregate components of cost. Expanded disclosures to provide insight about nature of plan and risks |

# Immediate recognition of all gains and losses

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- Plan may be in deficit even though employer is recognizing asset in balance sheet (or vice versa)
- Gains or losses might be recognized in P&L even though they arise from economic events that occurred in previous periods
- Two employers might have identical DBOs and plan assets but report different net amounts because gains and losses have arisen in different circumstances.

IAS 19 REVISION

- Remove all options that allow delayed recognition of gains and losses
- All actuarial gains and losses recognized immediately in OCI, not P&L
- Any cost arising from plan amendment recognized immediately in P&L (even if not vested)

# Immediate recognition of gains and losses - implications

Immediate recognition of gains and losses will normally:

- Improve transparency in financial statements
- Require one-off prior year adjustment to balance sheet as unrecognized gains/losses are recognized in prior OCI
- Increase volatility of balance sheet provision/prepayment
- Slightly reduce volatility of P&L charge

# NMH Example - Comparison of balance sheet figures before and after change

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**Before Change**

| | 2010 Rs m | 2009 Rs m | 2008 Rs m | 2007 Rs m | 2006 Rs m |
|---|---|---|---|---|---|
| The amounts recognised in the Statements of financial position: | | | | | |
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| Unrecognised actuarial (loss)/gain | (400) | (168) | (92) | 389 | 54 |
| **Balance sheet liability/(asset)** | **(61)** | **(49)** | **(37)** | **69** | **123** |

**After Change**

| | 2010 Rs' m | 2009 Rs' m | 2008 Rs' m | 2007 Rs' m | 2006 Rs' m |
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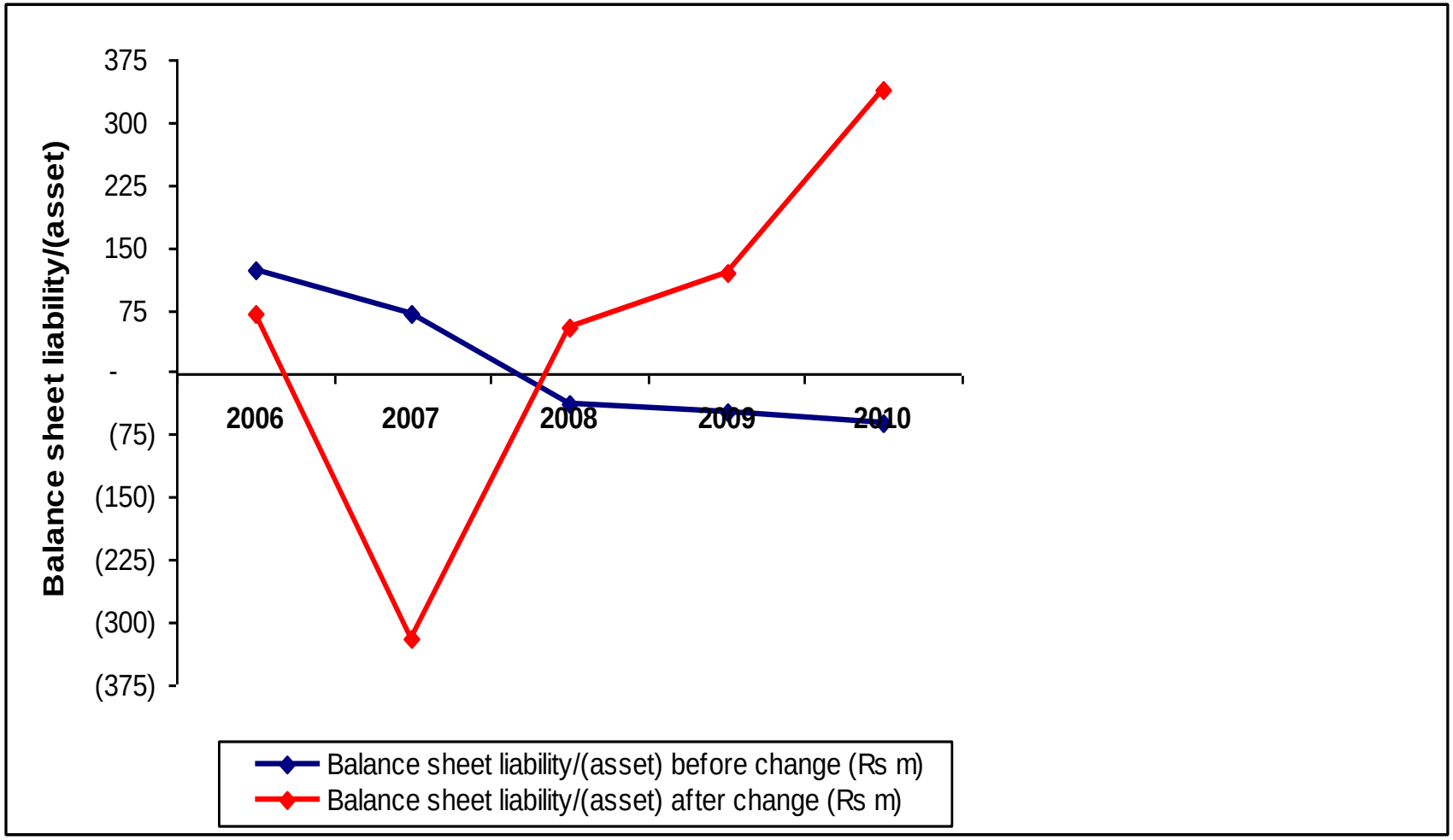
| The amounts recognised in the Statements of financial position: | | | | | |
| Defined benefit obligation | 2,079 | 1,877 | 1,728 | 1,424 | 1,316 |
| Fair value of plan assets | (1,740) | (1,758) | (1,673) | (1,744) | (1,247) |
| | 339 | 119 | 55 | (320) | 69 |
| **Net defined benefit liability/(asset)** | **339** | **119** | **55** | **(320)** | **69** |

# Balance sheet provision/prepayment more volatile



# SOCI – P&L & OCI Charge components

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THE ISSUE

- Currently companies allowed to present the P&L components in different categories. Difficult to compare companies with similar obligations. E.g:
  - interest cost can appear in different positions making it difficult to compare operating profit
  - actuarial gains/losses sometimes recognized in period in which they occur and sometimes not

IAS 19 REVISION

- No option. Companies will have to disaggregate the total charge into:
  - Service Cost
  - Net interest income or expense
  - Remeasurement

# P&L Charge components

SERVICE COST:

- Current service cost (CSC) as before
- PLUS all past service cost (PSC) immediately recognized (including unvested)
- PLUS curtailments and non-routine settlements

NET INTEREST INCOME/EXPENSE

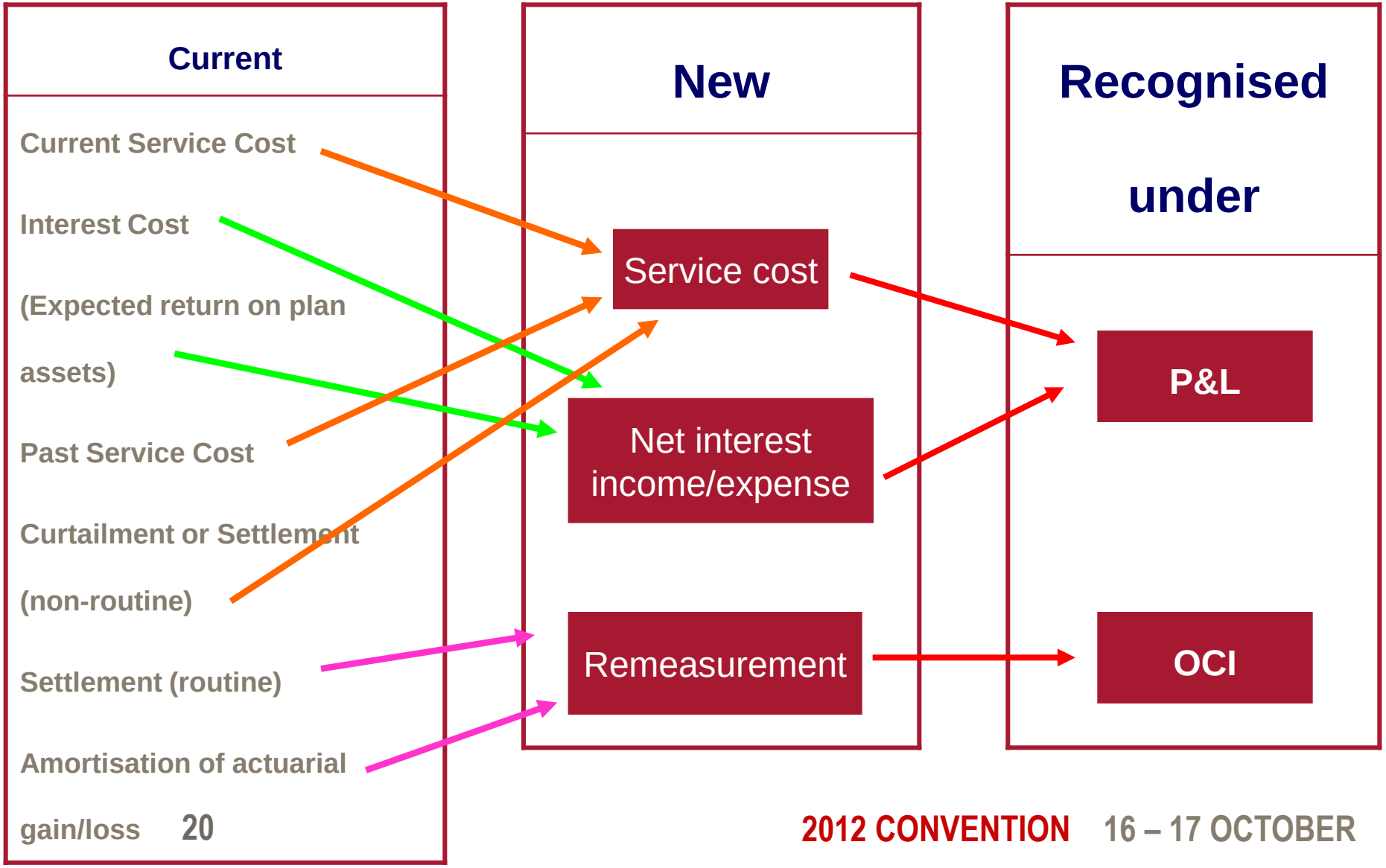
- Net interest income on funded surplus/deficit replaces interest cost on DBO and expected return on plan assets
- Currently, interest cost calculated using discount rate whereas expected return based on long term expected rate of return on plan assets (often higher than discount rate)

# OCI Charge components

REMEASUREMENT:

- Actuarial gains or losses on DBO
- Actuarial gains or losses on plan assets, i.e. actual return on plan assets less expected return already included in the net interest income or expense in P&L
- Any changes in the effect of the net assets limit excluding any amount already included in the net interest income or expense in P&L
- Also any routine settlement is also classified under "remeasurement"

# Current presentation v. new presentation



# NMH Example - Comparison of income statement figures before and after change (Version 1)

ACTUARIAL SOCIETY OF SOUTH AFRICA

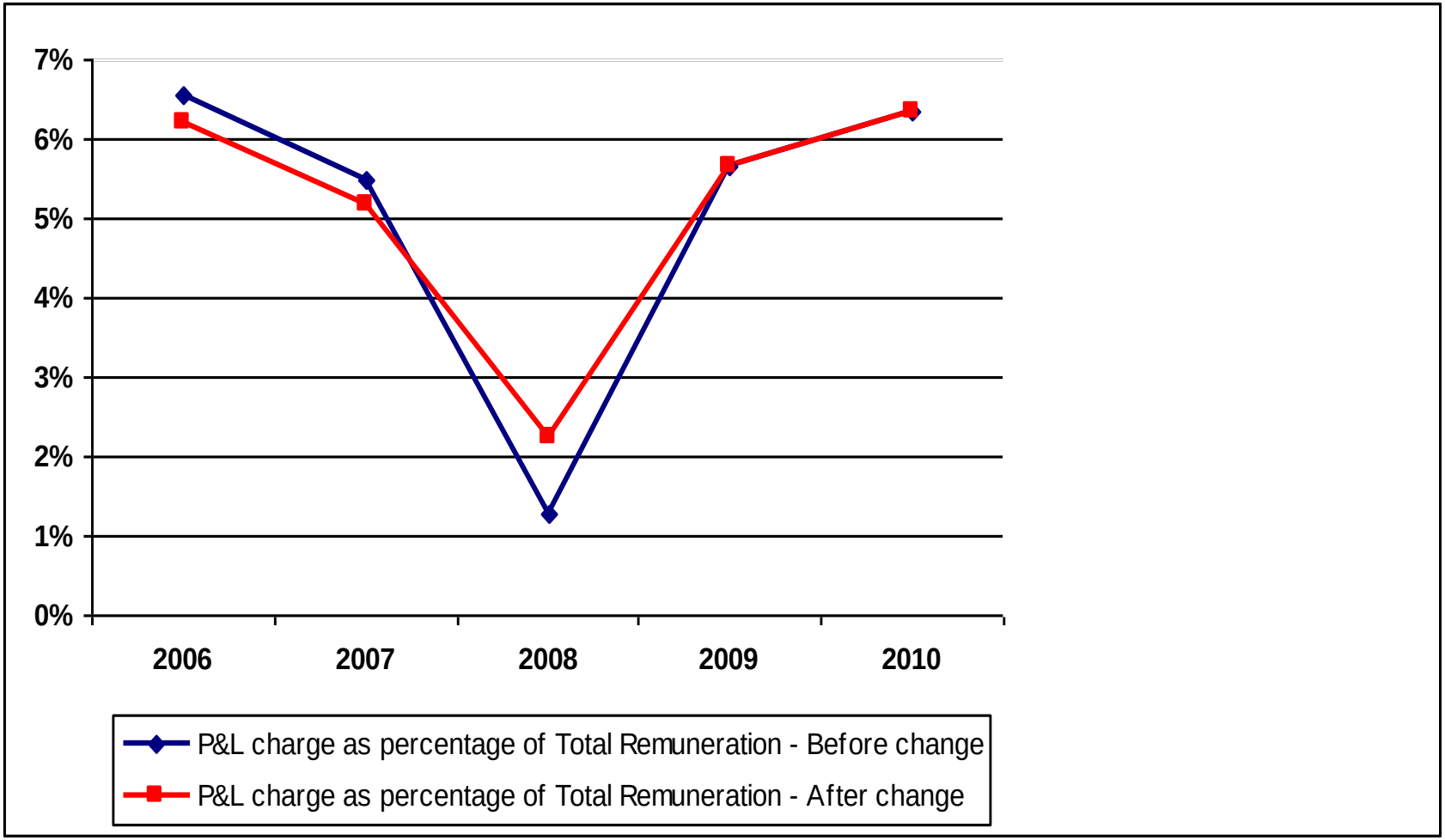
**Before change**

| | 2010 Rs m | 2009 Rs m | 2008 Rs m | 2007 Rs m | 2006 Rs m |
|---|---|---|---|---|---|
| The amounts recognised in the Income Statements: | | | | | |
| Current service costs | 71 | 69 | 63 | 51 | 48 |
| Interest cost on benefit obligation | 190 | 175 | 154 | 138 | 103 |
| Expected return on plan assets | (187) | (178) | (187) | (136) | (93) |
| Net actuarial (gain)/loss recognised in the year | - | - | (13) | 3 | 3 |
| Net benefit expense | 74 | 66 | 17 | 56 | 61 |

**After change**

| | | | | | |
|---|---|---|---|---|---|
| The amounts recognised in the Income Statements: | | | | | |
| Service cost | 71 | 69 | 63 | 51 | 48 |
| Net interest expense/(income) | 3 | (3) | (33) | 2 | 10 |
| P&L Charge/(Income) | 74 | 66 | 30 | 53 | 58 |
| | | | | | |
| Remeasurement | | | | | |
| Liability (gain)/loss | (13) | (60) | 131 | (68) | 114 |
| Assets (gain)/loss | 244 | 137 | 337 | (267) | (222) |
| Total OCI recognised | 231 | 77 | 468 | (335) | (108) |
| | | | | | |
| **P&L Charge and OCI** | **305** | **143** | **498** | **(282)** | **(50)** |

# NMH Example - Comparison of income statement figures before and after change (Version 1)



# NMH Example - Comparison of income statement (Version 2 – expected return based on discount rate)

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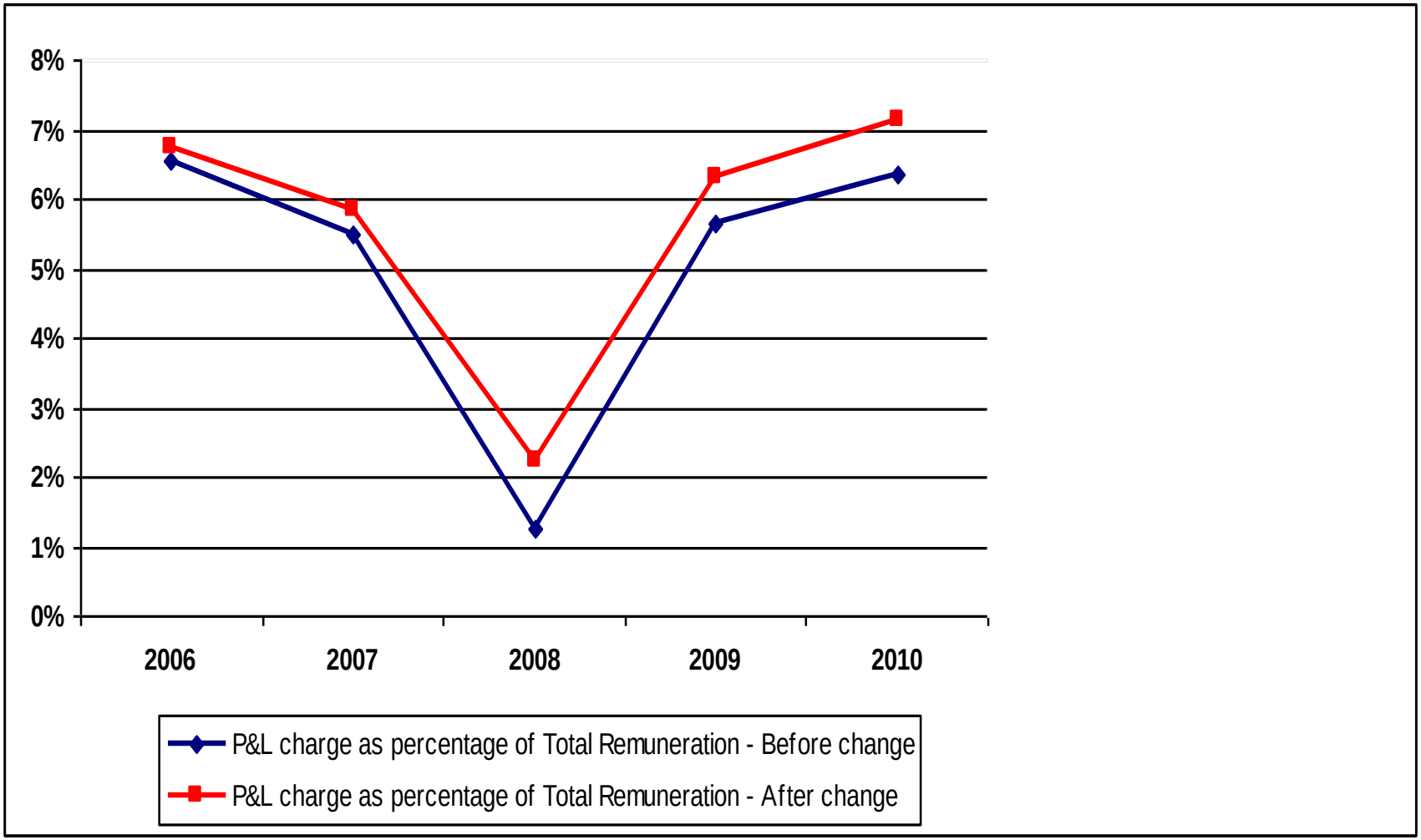
**Before change**

| | 2010 Rs' m | 2009 Rs' m | 2008 Rs' m | 2007 Rs' m | 2006 Rs' m |
|---|---|---|---|---|---|
| The amounts recognised in the Income Statements: | | | | | |
| Current service costs | 71 | 69 | 63 | 51 | 48 |
| Interest cost on benefit obligation | 190 | 175 | 154 | 138 | 103 |
| Expected return on plan assets | (187) | (178) | (187) | (136) | (93) |
| Net actuarial (gain)/loss recognised in the year | - | - | (13) | 3 | 3 |
| Net benefit expense | 74 | 66 | 17 | 56 | 61 |

**After change**

| | | | | | |
|---|---|---|---|---|---|
| The amounts recognised in the Income Statements: | | | | | |
| Service cost | 71 | 69 | 63 | 51 | 48 |
| Net interest expense/(income) | 12 | 5 | (33) | 9 | 15 |
| P&L Charge/(Income) | 83 | 74 | 30 | 60 | 63 |
| Remeasurement | | | | | |
| Liability (gain)/loss | (13) | (60) | 131 | (68) | 114 |
| Assets (gain)/loss | 236 | 128 | 337 | (274) | (227) |
| Total OCI recognised | 223 | 68 | 468 | (342) | (113) |
| **P&L Charge and OCI** | **306** | **142** | **498** | **(282)** | **(50)** |

# NMH Example - Comparison of income statement (Version 2 – expected return based on discount rate)



# Disclosure

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- Currently, too many disclosures about DB plans – reducing understandability and usefulness by obscuring important information
- Disclosures do not provide users of financial statements with an adequate basis to enable them to understand how DB plans affect the financial statements
- IAS 19 does not highlight information about risks arising from participation in DB plans

IAS 19 REVISION

- Disclose key characteristics of the company's DB plans
- Identify and explain the amounts recognized in the financial statements
- Describe how DB plans may affect the amount, timing and uncertainty of the entity's future cashflows

# Key Characteristics of DB Plans

Further additional disclosure required as follows:

- Risk exposure:
  - Narrative description of exposure to risk arising from involvement with the plan if plan assets are invested primarily in one class of investment.
  - For example, if it is property, the plan may expose the entity to a concentration of property market risk
- Narrative description of any plan amendments, curtailments or non-routine settlements

# Explain amounts in the financial statements (1)

Provide reconciliation from the opening to the closing balance of:

- Net defined benefit liability/(asset), showing separately:
  - Plan assets
  - Present value of defined benefit obligation
  - Effect of net assets limit if applicable

# Explain amounts in the financial statements (2)

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Each reconciliation must show each of the following if applicable:

- Service cost (split between current and past service)
- Net interest income or expense
- Remeasurements of net liability/(asset) showing separately:
  - Return on plan assets excluding amount in above net interest income
  - Actuarial gains/losses arising from liability experience
  - Actuarial gains/losses arising from changes in demographic assumptions
  - Actuarial gains/losses arising from changes in financial assumptions
  - Effect of limit on net assets excluding amount in above net interest income

# Explain amounts in the financial statements (3)

- Contributions to the plan showing separately the contributions from the employer and the plan participants
- Payments from the plan, showing separately the effect of any non-routine settlement
- Effects of any business combinations or disposals
- Foreign currency exchange

# Explain amounts in the financial statements (4)

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- Disaggregate fair value of plan assets into different assets showing risks and liquidity characteristics of each class. At minimum into:
  - Property
  - Government debt instruments
  - Other debt instruments
  - Equity divided into: local quoted and unquoted or other equity instruments

# Only some reduced disclosures!

- No longer need to disclose 5 year history of DBO, asset values, surplus/deficit and experience gains/losses (which was used to "check" appropriateness of assumptions)

# Other new disclosures

- Sensitivity analysis - effect of a change in each major actuarial assumption on the DBO at end of period
- Methods and assumptions used in preparing the sensitivity analysis
- Changes from previous period in the methods and assumptions used in preparing the sensitivity analysis
- Details of any asset/liability matching strategies used by the plan

# General comments on revised IAS 19

- Separation between P&L and OCI (lower volatility of P&L) helpful
- Immediate recognition of gains/losses in OCI helpful (but balance sheet more volatile)
- New disclosure requirements will considerably increase the level of both qualitative and quantitative disclosures for a DB plan.
- Particularly for entities that provide DB plans to employees in various countries, challenging task to ensure consistency and grouping, never mind presenting information in accounts in a way that is meaningful to users.

# Implications for employers and actuaries (1)

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- Prior year adjustment required in respect of immediate recognition of actuarial gains and losses accumulated to date:
  - How inconvenient?
  - How will market react for listed companies?
  - Consider early adoption of revised IAS 19 when convenient

# Implications for employers and actuaries (2)

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- Balance sheet liability/(asset) will be very volatile, thus affecting the net asset value of the company:
  - Will this encourage further shift from DB to DC?
  - Choice of assumptions more important (e.g. annual valuation v. triennial salary review distortions in Mauritius)

# Implications for employers and actuaries (3)

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- P&L charge less volatile:
  - Can this save DB? Too little too late?

- P&L charge slightly higher if expected return on assets was higher than discount rate:
  - Is this likely to be material?

# Implications for employers and actuaries (4)

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- Sensitivity analysis:
  - Difficulty to choose the key assumptions? Too many of them?
  - Already provided for medical costs; superseded now?
- Disclose any asset/liability matching strategies used by the plan:
  - May encourage serious thinking about them for first time?

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# FOR FURTHER INFORMATION, CONTACT:

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