



IFRSIC – POTENTIAL AGENDA ITEM REQUEST

I. The issue and current practice:

Contribution-based promises

In the past thirty years or so, there has been a trend globally away from pure defined benefit promises towards more contribution based promises. The rationale for this shift is for employers to transfer part, or all of, the actuarial risks related to pension obligations to the employees.

In a contribution-based promise, the amount of post-employment benefits received by the employee often depends on the actual return generated by the contributions.¹ That is, employees bear the risks and benefits related to investing the contributions made on their behalf. Some contribution-based promises, in addition, provide employees for a minimum return on the contributions. In Germany, for example, the relevant law on old age benefits requires for employees to at least receiving the amount contributed by their employers as post-employment benefits (ie protection against any loss of capital). Hence, should the return generated on the contributions fall short of the guaranteed minimum return, the employer covers for any balance. Stated differently, the employer bears the risk of the return on the contributions not generating the promised minimum return.

Consider the following example that will be used throughout the paper: In year 0, Employer A provides for a contribution in the amount of CU 1,000 to Employee B.² At the end of year 30, Employee B receives a post-employment benefit equal to the contribution plus the actual return generated on the contribution. The contribution is paid into a fund expected to generate a return of 6 per cent p.a. In addition, Employer A supports the post-employment benefit by guaranteeing a minimum return of 2 per cent p.a. on the contribution. That is, at the end of year 30 Employee B receives a post-employment benefit (PEB) being the contribution plus the higher of the actual return (r_a) on the contribution and the minimum return (r_m) of 2 per cent p.a.:

$$PEB_{30} = 1,000 \times \max\left[(1 + r_a)^{30}; (1 + r_m)^{30}\right]$$

While we believe the assumptions used in the example reflect a realistic scenario actual contribution-based promises may differ significantly.

¹ The paper focuses on funded plans that provide a benefit based on the assets in which the contributions are invested in, subject to a minimum return. This is because, in our experience, such plans are prevalent in practice.

² The contribution is made in arrears (ie at the end of year 0).



Accounting for contribution-based promises

Contribution-based promises carry elements of (1) defined contribution plans and (2) defined benefit plans. This is because contribution-based promises typically transfer a significant part of the actuarial risks associated with the related benefits to employees. It is our understanding that – because the employer retains some risks – contribution-based promises are generally accounted for as defined benefit plans. This is consistent with the IFRIC's tentative view, expressed in IFRIC Draft Interpretation D9 *Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions* [Draft D9]. In the example, Employer A retains the obligation to pay further contributions in the event that the fund does not hold enough assets to cover for the minimum return (ie 2 per cent) promised to Employee B.

The issuance of IAS 19 (2011) *Employee Benefits*, in our view, does not change the classification of contribution-based promises as *defined benefit plans*. Like IAS 19 (1998), the amended IAS 19 (2011) does not contain specific guidance on the accounting for contribution-based promises. The Board states in BC13 of IAS 19 (2011) that it will consider whether to develop proposals on contribution-based promises if it undertakes a comprehensive review of employee benefit accounting. Hence, the issue arises how to account for contribution-based promises applying the guidance in IAS 19 (2011). The 2008 Discussion Paper *Preliminary Views on Amendments to IAS 19 Employee Benefits* highlights the need for guidance on contribution-based promises:

The Board's intention in defining contribution-based promises is to capture those promises for which the measurement requirements of IAS 19 are difficult to apply.
[paragraph ITC8]

Hitherto, many preparers – in our understanding – account for contribution-based promises that provide for a minimum return according to IFRIC Draft Interpretation D9 *Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions* [Draft D9]. These preparers refer to the guidance laid out in Draft D9 despite the fact that no final interpretation has ever been issued on this topic. This is because the defined benefit methodology in IAS 19 was designed for benefits that do not depend on future return on assets. In the absence of specific guidance, preparers apply the guidance in Draft D9 to contribution-based promises. [The methodology in Draft D9 is illustrated further down in this paper.]

It is our understanding that the issuance of IAS 19 (2011) restarted a debate on the accounting for contribution-based promises – more specifically, the measurement of the present value of the related defined benefit obligations. While IAS 19 (2011) does not change the general methodology to measure defined benefit obligations – compared to IAS 19 (1998) – some view the clarifications on risk-sharing features in the Basis for Conclusions to affect the accounting for contribution-based promises.

The purpose of this paper is to reflect the discussion that is currently ongoing, and portraying potential impacts resulting from the different views. The paper focuses on the measurement of the defined benefit obligation and service cost related to contribution-based promises because these issues are most contentious. The 2 different views are illustrated by applying them to the above example.



View 1

According to View 1, IAS 19 (2011) requires Employer A in the example to measure the defined benefit obligation by projecting the benefit on the basis of current assumptions of future investment performance. Proponents of this view consider this consistent with estimating the ultimate cost of the benefit, which is the objective of the measurement of the defined benefit obligation, as stated in paragraph 76. In addition, proponents state this approach to be supported by BC143 ff. of IAS 19 (2011).

In the example, the expected return of 6 per cent reflects the current assumptions of future investment performance generated by the fund. Applying the expected return of 6 per cent to the contribution of 1,000 results in a projected benefit (PB) of 5,743 at the end of year 30:

$$PB_{30} = 1,000 \times (1 + 6\%)^{30} = 5,743$$

In order to determine the present value of the projected benefit paragraph 83 of IAS 19 (2011) requires the use of market yields on high quality corporate bonds. In the example, the rate used to discount (r_t) that is consistent with the term of the post-employment benefit obligation shall be 4.5 per cent. As a result, the present value (PV) of the post-employment benefit obligation amounts to 1,534 at the end of year 0, according to View 1:

$$PV_0 = 5,743 \times (1 + 4.5\%)^{-30} = 1,534$$

The present value of the defined benefit obligation resulting from employee service in the current period determines the related *current service cost* [paragraph 8 of IAS 19 (2011)]. As a result, Employer A shows corresponding current service cost in the amount of 1,534 in year 0. Assuming the contribution of 1,000 meets the definition of plan assets, Employer A recognises a net defined benefit liability of 534 at the end of year 0. In the statement of cash flows, Employer A reports cash outflows from operating activities in the amount of 1,000.³

To sum up, View 1 results in

(1) current service cost of 1,534 in the statement of income,

(2) a net defined benefit liability of 534, and

(3) cash outflows from operating activities of 1,000 in the statement of cash flows.

Whether, or not, Employer A will be required to make additional contributions in future periods in order to satisfy the post-employment benefit promised in year 0 to Employee B depends on the actual performance of the assets in the fund. Assume the fund generates a performance of 5 per cent p.a. - ie less than the expected 6 per cent p.a. – no additional contributions by Employer A are required. This is because the performance of the fund exceeds the promised minimum return of 2 per cent p.a. and thus, the fund holds enough assets to pay Employee B's post-employment benefits. As a result, applying View 1 results in overall service cost of 1,534 out of a single contribution amounting to 1,000. The balance between the service cost (1,534)

³ We are aware of a debate that discusses the classification of contributions to a fund in the statement of cash flows as operating, investing or financing. However, this discussion is not relevant to the topic discussed in this paper.



and the contribution (1,000) levels out over the 30 year period and is reflected in the corresponding remeasurements of the net defined benefit liability. It is of note that the service cost affect profit or loss while the remeasurements are recognised in other comprehensive income (and shall not be reclassified into profit or loss).

Excursus

The initial measurement of the defined benefit obligation and the corresponding current service cost, applying View 1, are sensitive to various factors:

- (1) term of the post-employment benefit obligation
- (2) current assumptions of future investment performance (ie expected return)
- (3) discount rate

Ad (1): The longer the term of the post-employment benefit obligation the more the contributions into a fund and the initial measurement of the defined benefit obligation and service cost, respectively, differ. Consider the following alteration to the above example: Employer A provides for an additional contribution in the amount of CU 1,000 to Employee C - the only difference compared to Employee B being that Employee C receives the related benefit at the end of year 5 (and not year 30). The discount rate commensurate with the term of the post-employment benefit obligation shall be 4.5 per cent (ie the yield curve runs horizontal). This results in a present value of the defined benefit obligation and correspondingly, current service cost of 1,074 (compared to 1,534 assuming a 30 year term):

$$PV_0 = 1,000 \times \frac{(1 + 6\%)^5}{(1 + 4.5\%)^5} = 1,074$$

Ad (2): A change in the current assumptions of future investment performance affects the initial measurement of the defined benefit obligation and correspondingly, the related service cost. Assume the current assumption of future investment performance, in the example, changes from 6 per cent to say 7 per cent. This results in an increase of the post-employment benefit obligation and correspondingly, service cost by 498 (from 1,534 to 2,032):

$$PV_0 = 1,000 \times \frac{(1 + 7\%)^{30}}{(1 + 4.5\%)^{30}} = 2,032$$

Ad (3): A change in the discount rate— similarly to a change in the current assumptions of future investment performance – impacts the initial measurement of the defined benefit obligation and correspondingly, the related service cost.

View 2

View 2 is of the opinion that the guidance in IAS 19 (2011) was designed for benefits that do *not* depend on future return on assets. Applying IAS 19 (2011) to contribution-based promises, therefore, requires constituents to sensibly interpret the relevant guidance in order to represent faithfully the substance and economic reality of contribution-based promises. View 2 acknowledges that the Board has provided for some additional guidance on the accounting for risk sharing features, specifically in



the Basis for Conclusions (BC143 ff.). This guidance seems to imply a methodology as laid out in View 1. This is because the Basis for Conclusions (BC147) states that paragraph 88 of IAS 19 (2011) requires preparers to reflect the best estimate of any future effect of conditional indexation in the measurement of the benefit obligation. According to paragraph 88:

Actuarial assumptions reflect future benefit changes that are set out in the formal terms of a plan [...] if, for example the entity is obliged [...] to use any surplus in the plan for the benefit of plan participants.

Indeed, paragraph 88 clearly refers to future benefit changes that are set out in the formal terms of a plan. However, View 2 interprets paragraph 88 to only require including future benefit changes if, and to the extent that, the plan is in surplus as of the end of the reporting period. Stated differently, only *actual* changes in the value of plan assets that the beneficiaries are entitled to shall be reflected in the measurement of the defined benefit obligation, according to View 2. This is because the employees are not entitled to future benefits that simply reflect expectations that have not yet occurred. Only once the plan is in surplus will the employee obtain a right to that surplus (and not before).

In contrast, the measurement of the defined benefit obligation – following View 2 – *should* reflect future benefits if, and to the extent that, those benefits have been guaranteed by the employer. This is because the corresponding right of the employee is no longer contingent on a future event (ie actual returns on the fund).

According to View 2, the requirements in IAS 19 (2011) shall be applied to plans with a combination of a guaranteed minimum return and a benefit that depends on future asset returns by analysing the benefits into (a) a fixed component and (b) a variable component. The fixed component comprises those benefits for which the amount that will ultimately be paid can be estimated without making assumptions about future returns on assets (ie the guaranteed minimum return in the example). The variable component comprises those benefits for which an estimate of the amount that will ultimately be paid requires assumptions to be made about future returns on assets (ie the expected return in the example). This approach is consistent with the guidance proposed in Draft D9.

The fixed component – ie the guaranteed minimum return in the example – is accounted for in accordance with the defined benefit methodology set out in IAS 19 (2011) by:

- (a) calculating the benefit to be paid in future by projecting forward the contribution at the guaranteed minimum return (ie 2 per cent in the example); and
- (b) discounting the benefits at the rate specified in IAS 19 (2011) to arrive at the present value of the defined benefit obligation (ie 4.5 per cent in the example).

Applying this methodology to the fixed component results in a present value of the benefit obligation amounting to 484:

$$PV_0 = 1,000 \times \frac{(1 + 2\%)^{30}}{(1 + 4.5\%)^{30}} = 484$$

The variable component – ie the expected return in the example – is only included into the measurement of the related defined benefit obligation if, and to the extent



that, actual returns materialise (any expected return). No projection forward of the benefits shall be made, and discounting of the benefit is therefore not required. Stated differently, the defined benefit obligation is measured at the fair value of the assets in the fund. At the end of year 0 when the contribution of 1,000 is made into the fund no return has been generated on the contribution. Accordingly, the defined obligation at the end year 0 does not reflect any return (ie 6 per cent in the example) on the contribution because the plan is not in surplus. Applying this methodology to the variable component results in a benefit obligation amounting to 1,000.

The (recognised) net defined benefit liability results after deducting the fair value of any plan assets from the carrying amount of the obligation. Any plan assets are measured and recognised in accordance with IAS 19 (2011) (ie 1,000). The defined benefit obligation that is included in the (recognised) net defined benefit liability is the higher of the fixed component and the variable component (ie 1,000).

To sum up, View 2 results in

- (1) current service cost of 1,000 in the statement of income,
- (2) a net defined benefit liability (asset) of 0, and
- (3) cash outflows from operating activities of 1,000 in the statement of cash flows.

In contrast to View 1, View 2 is not sensitive to the various factors: (1) term of the post-employment benefit obligation, (2) current assumptions of future investment performance (ie expected return) and (3) discount rate. That is, applying View 2 will always result in current service cost of 1,000 in year 0.

Issues to consider for the IFRS IC

As highlighted by the example, applying View 1 or View 2 to contribution-based promises is likely to result in significant differences in determining (i) the present value of the defined benefit obligation and (ii) current service cost. Proponents of View 1 and View 2 bring forward different arguments supporting their respective views.

View 1

Proponents of View 1 claim their view to be consistent with the guidance in IAS 19 (2011) and importantly, with the Board's rationale expressed in the Basis for Conclusions (BC143 ff.). Proponents of View 1 acknowledge that View 1 may result in an accounting mismatch. However, in their opinion this is not much different to accounting mismatches in other standards that the Board is aware of and accepts. In fact, the Board mentions in paragraph 148 of the Basis for Conclusions that it considered other changes to the measurement approach. However, the Board explicitly rejected those alternatives because they would require changing the fundamental measurement of the defined benefit obligation. Addressing these concerns was beyond the scope of the amendments made in 2011. As a result, View 1 does not see any room for judgement related to the accounting for contribution-based promises, applying IAS 19 (2011).



View 2

Proponents of View 2 do not object to the arguments made for View 1. However, proponents of View 2 believe that – considering the significance of the topic – proponents of View 1 have not enough reflected on the wording in IAS 19 (2011) given the specific facts and circumstances related to the example. In fact, IAS 19 (2011) refers to *conditional indexation* in general but does not specifically discuss contribution-based promises that provide for a return on assets in which the contributions are invested in. Such contribution-based promises, while representing one form of conditional indexation, carry some specifics that warrant thorough consideration when applying IAS 19 (2011), according to View 2.⁴ This is because an employer that sets up a *funded* plan has a different risk profile than an employer with an *unfunded* plan.⁵ This specifically applies if the funded plan provides for a return on assets in which the contributions are invested in. The employer with the unfunded plan carries the investment risk related to additional benefits contingent on returns on a virtual pool of assets, while the employer with the funded plan does not (except for any guaranteed minimum return).

Proponents of View 2 are of the opinion that in the example Employer A does not carry the risks and rewards associated with the conditional return generated by the contribution. This is because Employer A only passes on the return generated in the fund. Any future benefit changes only become unconditional once the contributions in the fund have generated the corresponding benefit. Accordingly, such a plan does *not* create actuarial risk for the entity (except for any guaranteed minimum return): In the (unlikely) event that the ultimate cost of benefits earned matches the expected return (ie 6 per cent), the entity will *not* have to increase its contributions into the plan.

Including projected *future* benefits into measuring the defined benefit obligation, therefore, results in including amounts that Employer A has no *present* obligation to provide for. Thus, View 2 questions whether projected benefits that are contingent on future events (ie future performance on contributions), in fact, meet the definition of a liability in the Board's *Framework*:

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

According to View 2, a present obligation only exists once the contributions in the fund have generated a return, reflected in the fair value of the fund. In other words, a potential outcome of View 1 could be the recognition of items that do not meet the definition of a liability.

Proponents of View 2, therefore, believe that the term 'mismatch' used by proponents of View 1 does not appropriately reflect the effect View 1 has on the defined benefit obligation. They argue View 1 requires entities to apply a present value technique that has no economic relevance. View 1 results in projecting forward future benefits

⁴ IAS 19 (2011) does not define the term 'conditional indexation'. Referring to the Basis for Conclusions, it is the submitters' understanding that contribution-based promises represent one form of conditional indexation.

⁵ Some jurisdictions may require entities to invest the contributions into specifically dedicated funds, managed independently from the sponsoring entity.



at an expected rate of return and discounting back to present value based on an IAS 19 (2011) discount rate. Since the IAS 19 (2011) discount rate does not mirror the profile of the assets that determine the expected return used in projecting forward future benefits, View 1 does not result in meaningful information and hence, does not faithfully represent the transaction in the example. Importantly, View 1 results in an overstatement in the current service cost affecting profit or loss in year 0, proponents of View 2 argue. The subsequent reversal of this effect, however, qualifies as re-measurement and therefore, does not affect profit or loss (explained in more detail above). Hence, View 1 does not adequately provide information about the performance, in particular the profitability, of Employer A.

Proponents of View 2 think it is important to thoroughly reflect the guidance in IAS 19 (2011) to contribution-based promises in order to appropriately account for the specific facts and circumstances in the example. Paragraph 88 of IAS 19 (2011) requires actuarial assumptions to reflect future benefit changes if

'the entity is obliged [...] to use any surplus in the plan for the benefit of plan participants'.

However, according to View 2, this does not stipulate Employer A to include projected future benefits into the measurement of the defined benefit obligation as long as the plan is not in a surplus. In other words, paragraph 88 only requires Employer A to include *actual* returns into the measurement of the defined benefit obligation that have been recognised in the financial statements. This is because only actual returns create a surplus that is available to Employee B and hence, creates a present obligation on behalf of Employer A.

In addition, proponents of View 2 are of the opinion that – in the example – including projected future benefits into measuring the defined benefit obligation is *not* consistent with the requirements in paragraph 76 of IAS 19 (2011), stating that

'actuarial assumptions are an entity's best estimates of the variables that will determine the ultimate cost [emphasis added] of providing post-employment benefits.'

This is because the projected future benefits in the example (ie 6 per cent) do *not* faithfully reflect the ultimate cost of Employer A, proponents of View 2 state.

Overall, proponents of View 2 believe that applying their view to the example does not contradict to the guidance in IAS 19 (2011). This is because the example represents a form of conditional indexation with unique features, not reflected in the general guidance in the Basis for Conclusions of IAS 19 (2011) [BC143 ff.]. In addition, proponents of View 2 argue their view to provide information that is more decision useful because it more faithfully reflects the transaction compared with View 1.⁶

Submitters' recommendation

The submitters are aware that the accounting for contribution-based promises is a complex area that standardsetters and constituents alike have tried to address at several occasions in the past. The submitters, therefore, do not believe the IFRS IC

⁶ It is of note that, for example, the actuarial profession in Germany issued guidance about seven years ago, addressing the accounting for contribution-based promises. Their approach effectively supports View 2.



can provide guidance to this contentious issue on a timely basis. The discussion in connection with the development of Draft D9 illustrates this.

On the other hand, contribution-based promises, in our experience, represent a continuously growing form of post-employment benefits. In times of significant demographic changes, contribution-based promises are a means for employers to appropriately balance the risks related to post-employment benefits between employers and employees (and typically, reduce the risks and rewards from an employer perspective). Therefore, it is not surprising that for some multinationals contribution-based promises have become the major form of post-employment benefits. As a result, applying View 1 or View 2 will result in significant differences in terms of (i) the present value of the related defined benefit obligation and (ii) current service cost.

While understanding the arguments of both views the submitters consider View 2 to more appropriately reflect the specific facts and circumstances in the example presented in the paper. View 2 provides information that is more decision useful to users of financial statements (in contrast, View 1 does not reflect the substance and economic reality of the example). However, the submitters acknowledge that contribution-based promises may take a variety of forms and that applying View 2 to other facts and circumstances may not be appropriate.

Considering the complexity of the issue and the current debate about the accounting for contribution based promises, the submitters are of the opinion that it would help constituents if the IFRS IC expresses a view as to whether either:

- (a) the accounting for contribution-based promises according to IAS 19 (2011) is unambiguous and leaves no room to reflect the specific facts and circumstances of the relevant transactions (ie View 1); or
- (b) IAS 19 (2011) indicates some form of accounting but that the guidance in IAS 19 (2011) does not preclude differing interpretations depending on the specific facts and circumstances of the relevant transactions (ie View 2).

In light of the pending adoption of IAS 19 (2011) the submitters appreciate a prompt reaction by the IFRS IC in order to provide for a consistent accounting on this important topic. This is relevant, all the more, as the application of View 1 is likely to have an impact on how employers allocate (or reallocate) the assets in which the contributions are invested in because this will have a direct impact on (i) the present value of the related defined benefit obligation and (ii) the current service cost that entities are accounting for.



II. Reasons for the IFRS IC to address the issue:

a) Is the issue widespread and has it practical relevance?

Based on investigations and inquiries made, it was confirmed that the issue as described in this document is widespread and of practical relevance. Based on our investigations the issue applies to a number of jurisdictions worldwide⁷.

b) Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?

As outlined above – there are currently two views in discussion, which lead to the expectation that significantly divergent interpretations will emerge under IAS 19 (2011).

c) Would financial reporting be improved through elimination of the diversity?

Financial reporting would greatly be improved by clarifying this issue since the magnitude of contribution based promises can be significant for single prepares. If divergent interpretations and practices will not be prevented, information about a reporting entity may not be compared with similar information about other entities. Therefore, an appropriate clarification would enhance comparability among companies' financial reporting.

d) Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and *Framework for the Preparation and Presentation of Financial Statements*, but not so narrow that it is inefficient to apply the interpretation process?

We are of the opinion that the issue is sufficiently narrow in order to be addressed by the IFRS IC.

e) If the issue relates to current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project? (The IFRS IC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRS IC would require to complete its due process).

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⁷ It is our understanding that the accounting for contribution-based promises is an internationally widespread issue with practical relevance (according to information made available to us it is – for example – also an issue in Switzerland, BeNeLux, Israel and arguably in the US). In this context it should also be noted that **The Swedish Financial Reporting Board** has sent a letter dated 16 March 2012 to the IASB addressing this issue.