IFRS

STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**IAS 19 *Employee benefits***		
Paper topic	Accounting for contribution-based promises		
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Introduction

1. The IFRS Interpretations Committee (the Committee) received a request to clarify the accounting for contribution-based promises in accordance with IAS 19 *Employee Benefits*. The objective of this Agenda paper is to provide the Committee with background on the issue. The paper also provides a summary of the staff's research and analysis to date on the issue. Finally, the staff are seeking views and guidance from the Committee to how it would like to proceed with the issue.

2. This agenda paper includes:

   (a) background information on the issue;

   (b) staff analysis to date;

   (c) outreach activities to date;

   (d) assessment of the issue against the Committee's agenda criteria; and

   (e) staff recommendation and question for the Committee.

Background

3. In March 2012, the Committee received a request seeking clarification on how to measure the present value of the defined benefit obligation related to contribution-based promises under IAS 19. The submitter describes contribution-based promises as post-employment benefit promises, by which the amount of benefits received by the employee depends on the actual return generated by the contributions. These promises may or may not have a guaranteed return.

4. The submitter's understanding is that many preparers are currently accounting 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*, despite the fact that no final interpretation was issued. This is, in the submitter's opinion, because the defined benefit methodology in IAS 19 was designed for benefits that do not depend on future returns on assets, and in the absence of specific guidance on the issue, some preparers apply the draft guidance in D9 to these contribution-based promises (see paragraph 15 for a summary of the proposals in D9).

5. The submitter says that the issue of the revised IAS 19 in 2011 restarted a debate on how to account for contribution-based promises. More specifically, the submitter says that some hold the view that the clarifications made in 2011 on risk-sharing features in the revised standard may affect the accounting for contribution-based promises. This is despite the fact that there were no fundamental changes to the general methodology for measuring defined benefit obligations.

6. According to the submitter, there are two views on how to measure the present value of the defined benefit obligation related to contribution-based promises. In summary those two views are:

   (a) View 1: Measure the defined benefit obligation as the whole of the expected benefit arising from the contribution-based promise, using the projected unit credit method set out in IAS 19. This is done by projecting the benefit on the basis of current assumptions of future

investment performance, and discounting those amounts using the discount rate specified by IAS 19 (generally a high quality corporate bond rate).

(b) View 2: Apply the projected unit credit method set out in IAS 19 only to the part that has been guaranteed by the employer. Any surplus in the assets over and above the guaranteed amount is included in the measurement of the defined benefit obligation at the amount of the surplus at the reporting date, ie the employee will only obtain a right to the surplus once the benefit plan has achieved that surplus.

View 1

7. According to View 1, IAS 19 (as revised in 2011) requires employers to measure contribution-based promises as the whole of the expected benefit arising from the contribution-based promise using the projected unit credit method set out in IAS 19. This is done by projecting the benefit on the basis of current assumptions of future investment performance and then discounting those amounts using the discount rate specified by IAS 19 (generally a high quality corporate bond rate). Proponents of this view consider this to be 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 of IAS 19. In addition, proponents of this view state that this approach is supported by paragraph BC143 of IAS 19.

> BC143 The amendments made in 2011 clarify that:
>
> (a) the effect of employee and third-party contributions should be considered in determining the defined benefit cost, the present value of the defined benefit obligation and the measurement of any reimbursement rights.
>
> (b) the benefit to be attributed to periods of service in accordance with paragraph 70 of IAS 19 is net of the effect of any employee contributions in respect of service.

(c) any conditional indexation should be reflected in the measurement of the defined benefit obligation, whether the indexation or changes in benefits are automatic or are subject to a decision by the employer, the employee or a third party, such as trustees or administrators of the plan.

(d) if any limits exist on the legal and constructive obligation to pay additional contributions, the present value of the defined benefit obligation should reflect those limits.

View 2

8. According to View 2, the guidance in IAS 19 (as revised in 2011) is designed for benefits that do not depend on future return on assets. Applying IAS 19 to contribution-based promises, therefore, requires constituents to interpret the relevant guidance in order to represent faithfully the substance and economic reality of these promises.

9. Under View 2, paragraph 88 of IAS 19 is interpreted to require including future benefit changes only if, and to the extent that, the plan is in surplus as of the end of the reporting period. Stated differently, the measurement of the defined benefit obligation shall reflect only actual changes in the value of plan assets that the beneficiaries are entitled to. This is because the employees are not entitled to future benefits that simply reflect expectations that have not yet occurred.

10. Under View 2, the requirements in IAS 19 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.

11. The fixed component (ie the guaranteed minimum) comprises those benefits for which the amount that will ultimately be paid can be estimated without making assumptions about future returns on assets. The variable component (ie the expected additional return) comprises those benefits that will only become payable to the extent that there is a surplus (over and above the guaranteed

minimum) in the plan at the employee's retirement date. View 2 only recognises an obligation for the variable component to the extent of any surplus at the reporting date. The submitter states that this approach is consistent with the guidance proposed in IFRIC Draft Interpretation D9.

12. The fixed component—ie the guaranteed minimum return—is accounted for in accordance with the defined benefit methodology set out in IAS 19 by:

    (a) calculating the benefit to be paid in future by projecting forward the contribution at the guaranteed minimum return; and

    (b) discounting the benefits at the rate specified in IAS 19 to arrive at the present value of the defined benefit obligation.

13. The variable component—ie the amount over and above the guaranteed minimum return—is only included in the measurement of the related benefit obligation if, and to the extent that, actual returns materialise. No projection forward and discounting back of the benefit is performed. Instead the variable component of the defined benefit obligation is measured at the fair value of the assets.

Question submitted

14. Because the submitter acknowledges that accounting for contribution-based promises is a complex and highly controversial issue, the submitter is of the opinion that it would help constituents if the Committee expressed a view as to whether either:

    (a) the accounting for contribution-based promises according to IAS 19 (as revised in 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 provides an accounting model but that the guidance in IAS 19 does not preclude differing interpretations depending on the specific facts and circumstances of the relevant transactions, ie View 2.

Staff analysis

History

15. The problems entities face in accounting for contribution-based promises under IAS 19 are well known. The Committee has previously looked at this issue and in 2004 it issued IFRIC Draft Interpretation D9. D9 set out accounting proposals for defined benefit plans when the benefit depends on future returns on assets, with or without an accompanying guarantee of a fixed return. In summary D9 proposed:

    (a) For plans with a guarantee of fixed return, the accounting for defined benefit plan under IAS 19 should apply.

    (b) For a benefit that depends on future asset returns, the plan liability shall be measured at the fair value of the assets upon which the benefit is specified. If the benefit includes a specific margin on future assets returns, the effects of that margin shall be added to or deducted from the fair value.

    (c) For plans with a combination of a guaranteed fixed return and a benefit that depends on future asset returns, the benefits should analysed into a fixed component and a variable component.

        (i) 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. The fixed component shall be accounted as a defined benefit plan under IAS 19.

        (ii) 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. The variable component shall be accounted for at the fair value of the assets upon which the benefit is specified. If the benefit includes a specific margin on future asset returns, the effects of that margin shall be added to or deducted from the fair value.

16. The responses to D9 indicated that the majority of respondents broadly supported the principle of using defined benefit accounting for plans that fall within its

scope. However, further clarification was requested in respect of the scope of D9, and, in particular, on the distinction between defined contribution and defined benefit plans. In addition, a significant minority of the respondents disagreed with the detailed requirements of the proposed calculation methods, when measuring the benefit obligation. The main issued raised regarding measurement were:

(a) the value of any embedded guarantees/options;

(b) the fixed/variable distinction; and

(c) the appropriateness of the discount rate used.

17. Finally, respondents also raised concerns about convergence with US GAAP.

18. After redeliberations, the Committee decided to stop work on D9 and in November 2006 the Committee referred it to the Board's project on Post-employment benefits, with the intention of revisiting the issue if the Board's project failed to deal with it.

19. The Board picked up the issue and in the Discussion paper *Preliminary Views on Amendments to IAS 19* Employee Benefits, it outlined an approach to overcoming the measurement defect in IAS 19. The approach was based on defining a new category of promises—contribution-based promises—and measuring them at fair value, assuming the terms of the benefit promise do not change.

20. Most respondents were critical of the Board's proposals for contribution-based promises. Some stated that the proposals would cause more problems than the current requirements in IAS 19. In particular:

(a) The scope of contribution-based promises, as defined in the discussion paper, was too wide. The Board should restrict the scope to promises that cause problems when they are accounted for using IAS 19.

(b) The measurement proposed represented a fundamental change in measurement for many post-employment benefit plans. It would be preferable, and possible, to deal with the troublesome promises within the existing framework of IAS 19.

21. In the light of the responses received, the Board decided not to continue with the proposals on contribution-based promises until it could carry out a comprehensive

review of pension accounting and since then the Board has done no further work on the issue.

Submission request

22. The submission notes the complexity of the issue and the lack of guidance and is seeking clarification on whether the revisions to IAS 19 in 2011 affect how entities should account for contribution-bases promises. The staff believes that there are two underlying questions in the submission:

    (a) how to account for contribution-based promises; and

    (b) did the amendments to IAS 19 in 2011 change or affect the accounting for contribution-based promises.

23. Paper 14A for this meeting deals with question (a) while this paper deals with question (b).

24. The research that the staff have done on the issue confirms that accounting for contribution-based promises is a highly controversial issue and it seems clear that the question of how to account for these promises needs to be addressed. A further analysis of the issues can be found in Agenda paper 14A for this meeting.

Assessment of impact of 2011 revisions to IAS 19 on accounting for contribution-based promises

25. The amendments to IAS 19 in 2011 made changes to the accounting for the defined benefit obligation in connection with some risk-sharing features. The staff's research indicated that the Board's intention was to clarify that if the employer is not required to meet the entire cost of a benefit plan, the measurement of defined benefit obligations reflects that fact. However, the revisions in 2011 were not intended to change the accounting for employee benefits whose ultimate amount is variable and depends on the return on particular assets.

26. The changes on risk-sharing in the 2011 revision, which are referred to in the submission, do not, in the staff's opinion, affect contribution-based promises. This is because the nature of the risk-sharing that was addressed by the 2011 amendment was where the amount of the pension promise remains unchanged, but the cost of that pension promise is shared between the employee and the

employer. In contrast, for contribution-based promises the amount of the pension promise varies according to the returns on the plan assets. The reason an employer may choose to use this form of promise is to decrease the investment risk it faces. It does not enable the employer to share the actuarial risk associated with the benefit obligation with the employee.

27. Accordingly, if an approach to account for contribution-based promises was considered acceptable before the revisions in 2011, we think it would still be acceptable after those revisions. In support of this view, we also note that addressing concerns about contribution-based promises was explicitly excluded from the scope of the revisions and the Board makes that point in paragraph BC148 of the Basis for Conclusions of the revised standard. We note, however, that if a contribution-based promise also included the risk-sharing arrangements that were the focus of the 2011 amendments to IAS 19, then that aspect of the accounting for such a pension arrangement would be affected by the amendments in that regard.

Outreach activities

28. We sent a request for information to the National Standard Setters Group in order to help assess the Committee's agenda criteria. Specifically, we asked:

    (a) Are contribution-based promises common in your jurisdiction?

    (b) If yes, how are contribution-based promises under IAS 19 accounted for in your jurisdiction of influence?

29. We also indicated that at this stage of the process we were mostly interested in observations about the issue in practice.

30. The request was still outstanding when this agenda paper was completed. We will provide the Committee with an update of the results of this outreach at the May Committee meeting.

Agenda criteria

31. The staff's preliminary assessment of the agenda criteria is as follows:

    (a) *The issue is widespread and has practical relevance.*

    Previous feedback that the Committee and the Board have received on the issue indicate that it may be widespread, but the staff will provide an oral update on this at the May meeting after considering the results of the outreach undertaken. As for its practical relevance, the issue has practical relevance because it is not clear how to account for contribution-based promises in accordance with IAS 19.

    (b) *The issue indicates that there are significant divergent interpretations (either emerging or existing in practice).*

    There seem to be divergent interpretations in Germany based on the submission. As for how widespread the divergence is in other jurisdictions, the staff will provide an oral update on the results of the outreach on the issue. However, previous work on the issue has indicated that divergence existed under current IAS 19.

    (c) *Financial reporting would be improved through the elimination of the diverse reporting methods.*

    Yes.

    (d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*

    The staff is of the opinion that the issue could be resolved by the Committee, however that will depend on how the scope of the issue is defined. The broader the scope of the issue, the longer it is likely to take to resolve it. One option would be for the Committee to revisit Draft Interpretation D9.

    (e) *It is probable that the Committee will be able to reach a consensus on the issue on a timely basis.*

It is unclear to the staff whether the Committee would be able to reach a consensus. This would depend on the route the Committee would take regarding the issue.

(f) *If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project?*

Because there is currently no project relating to employee benefits on the Board's agenda, this does not apply. The Board deferred consideration of contribution-based promises after receiving responses to the discussion paper issued in 2008. Whether the Board decides to take on a project on post-employment benefits is therefore subject to the results of the ongoing agenda consultation process.

Staff recommendation

32. The request submitted is not asking the Committee to address the accounting for contribution-based promises; it notes the complexity of the issue and the submitter is therefore seeking clarification on whether the revisions to IAS 19 affect the accounting for these promises.

33. The staff are of the opinion, after initial research, that the changes made to IAS 19 in 2011 should not affect the accounting for contribution-based promises. More specifically the Board was not considering contribution-based promises, because it had excluded them from the scope of the revisions and so any changes made in the revisions that are perceived as having affected accounting for contribution-based promises were unintended.

34. On this basis, while there is a need to clarify how IAS 19 applies to contribution-based promises, the accounting for contribution-based promises should not be affected by the revised standard.

35. The staff also think that if the Committee wants to address contribution-based promises, it might instead consider other options, such as revisiting Draft Interpretation D9. Consequently, the staff are bringing a separate paper, paper 14A, on D9 to the Committee at this meeting.

36. On this basis, the staff recommend that the Committee should not add this issue to its agenda and should instead consider revisiting Draft Interpretation D9. The proposed wording of the agenda rejection is included in Appendix B.

Question for the Committee
Does the Committee agree with the staff analysis and conclusion?

Appendix A—potential agenda item request

Issue

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 (*ri*) that is consistent with the term of the postemployment 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.

[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.

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) 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

[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.

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 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 remeasurement 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 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

[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.

(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 worldwide[7].

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.

[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.

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).

N.A.

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Appendix B—proposed wording for the agenda decision

B1. We propose the following wording for the agenda decision:

IAS 19 *Employee Benefits*—Accounting for contribution-based promises

The Interpretations Committee received a request seeking clarification about the measurement in accordance with IAS 19 (2011) of the present value of the defined benefit obligation related to contribution-based promises. An underlying concern in the submission was whether the revisions to IAS 19 in 2011, which clarified the treatment of risk-sharing features related to defined benefit obligations, affect the accounting for contribution-based promises.

The Committee notes that the 2011 amendments to IAS 19 that clarified the treatment of risk-sharing features address arrangements in which the amount of the pension promise remains unchanged, but the cost of that pension promise is shared between the employee and the employer. This contrasts with contribution-based promises, in which the amount of the pension promise varies according to the return on the plan assets. Accordingly, the Committee do not expect the 2011 amendments to IAS 19 relating to risk-sharing arrangements to cause changes to the accounting for contribution-based promises, unless those contribution-based promises also include similar risk-sharing arrangements. The Committee also noted that the Board expressed a similar view in paragraph BC148 of the revised standard.

On the basis of the analysis described above, the Committee [decided] not to add the issue to its agenda.