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Project	<b>New items for initial consideration</b>
Topic	<b>IAS 19 <i>Employee Benefits</i> – Accounting for statutory employee profit-sharing arrangements</b>

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### Purpose of this paper

1. The purpose of the paper is to respond to a request received by the Committee to address the accounting for statutory employee profit-sharing arrangements.
2. The request identifies existing, and emerging, diversity in applying the guidance in IAS 19 *Employee Benefits* to account for statutory employee profit sharing arrangements when the employee benefit is computed based on **taxable** profit.
3. These arrangements, although acknowledged to exist in certain other jurisdictions, are specifically identified as existing in Mexico.
4. This paper:
  - (a) provides background information;
  - (b) analyses the issue raised in the context of IFRSs;
  - (c) makes a staff recommendation for the Committee agenda decision; and
  - (d) asks the Committee whether they agree with the staff recommendation.

### Background information

5. In April 2010, the Committee received a request asking how an entity should account for statutory employee profit-sharing arrangements when the employee benefit is computed based on **taxable** profit, such as those that currently exist in Mexico (Mexican employee profit-sharing arrangement).

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

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRS Interpretations Committee or the IASB. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

Decisions made by the IFRS Interpretations Committee are reported in *IFRIC Update*.

Interpretations are published only after the IFRS Interpretations Committee and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in *IASB Update*.

6. The Mexican employee profit-sharing arrangement is a statutory requirement for all business enterprises in Mexico (subject to certain limited exemptions<sup>1</sup>) to pay employees a fixed percentage share of the taxable profit of the entity. These amounts are payable to the employees within 60 days of the deadline for the entity's annual tax payments.
7. The employees' share of the taxable profit of the entity for the purpose of the Mexican employee profit-sharing arrangement is computed at 10 per cent of taxable profit. Taxable profit is defined on a basis consistent with Mexican tax law, subject to some limited exceptions<sup>2</sup>.
8. The total amount that an entity will pay at 10 per cent of taxable profit is divided into two equal parts. The first half is allocated to individual employees, based on the number of working days during the year, and the second half is allocated to individual employees based on their salaries, subject to a certain ceiling.
9. Employees who joined or left the entity during the year, or who left the entity after the reporting period, are still eligible to receive their allocated share of the taxable profit of the year, if they worked for the entity for 60 or more days during the year.
10. The request identifies that the Mexican employee profit-sharing arrangement is within the scope of paragraph 4 of IAS 19 *Employee Benefits* which states:

Employee benefits include:

- (a) **short-term employee benefits**, such as wages, salaries and social security contributions, paid annual leave and paid sick leave, **profit-sharing** and bonuses (**if payable within twelve months of the end of the period**) and non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

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<sup>1</sup> Exemptions are provided for newly established business enterprises for a certain period of time, certain public interest institutions and certain small and medium-sized business enterprises.

<sup>2</sup> Certain items are added to, or subtracted from, taxable profit in computing a base to which the 10 per cent profit sharing amount is applied. For example, dividend income is included in the base for profit-sharing purposes, and depreciation is based on historical cost rather than on an amount adjusted for inflation. However, such adjustments were challenged in the Supreme Court and now many business enterprises are using taxable profit directly.

- (b) post-employment benefits such as pensions, other retirement benefits, post-employment life insurance and post-employment medical care;
- (c) **other long-term employee benefits**, including long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, **profit-sharing**, bonuses and deferred compensation; and
- (d) termination benefits.

Because each category identified in (a)–(d) above has different characteristics, this Standard establishes separate requirements for each category. [emphasis added]

11. If a profit-sharing arrangement meets the definition of a short-term employee benefit in accordance with IAS 19.4(a), an entity recognises a liability in accordance with IAS 19.10:

**When an employee has rendered service** to an entity during an accounting period, the entity shall recognise the **undiscounted amount** of short-term employee benefits **expected to be paid** in exchange for that service:

- (a) ...

[emphasis added]

12. If a profit-sharing arrangement is instead other long-term employee benefit, an entity recognises a liability for the long-term employee profit sharing in accordance with IAS 19.128:

The amount recognised as a liability for other long-term employee benefits shall be the net total of the following amounts:

- (a) **the present value of the defined benefit obligation** at the end of the reporting period (see paragraph 64);
- (b) minus the fair value at the end of the reporting period of plan assets (if any) out of which the obligations are to be settled directly (see paragraphs 102–104).

In measuring the liability, an entity shall apply paragraphs 49–91, excluding paragraphs 54 and 61. An entity shall apply paragraph 104A in recognising and measuring any reimbursement right. [emphasis added]

13. IAS 19.7 defines the present value of the defined benefit obligation as follows:

The *present value of a defined benefit obligation* is **the present value**, without deducting any plan assets, **of expected future payments** required to settle the obligation resulting from employee service in the current and prior periods. [emphasis added]

14. The Mexican employee profit-sharing arrangement is generally a short-term employee benefit, because it is paid within five months from the end of the reporting period. If a deferred component (see paragraphs 19-22 below) is recognised, it could be a long-term employee benefit, because temporary differences relating to the deferred component will be included in taxable income in future years, and the payment to employees will be paid more than 12 months after the end of the reporting period.

### Staff Analysis

15. In applying this guidance in IAS 19, the staff identified two potential components of the employee benefit. These were:
- (a) a current component; and
  - (b) a deferred component.

#### ***Current component of the employee benefit***

16. The current component is calculated as 10 per cent of the defined taxable profit of the entity.
17. The staff are not aware of any existing, or emerging diversity in practice in accounting for this current component of the employee benefit. We understand that entities recognise this current component as a liability in the current reporting period, in accordance with IAS 19.10, as a short-term employee benefit.
18. We concur with this approach to accounting for the current component of the employee benefit.

***Deferred component of the employee benefit***

19. The request notes that some constituents also identify a deferred component relating to the employee benefit.
20. Their argument is based on an analogy with deferred income tax. That is, a deferred component exists as a separate asset or liability at the end of the reporting period, because there are differences between the carrying amount and tax base of an asset or liability on the statement of financial position. Those differences will result in an increase or decrease of the amount that the entity would otherwise have to pay to its employees under the employee profit-sharing arrangement.
21. Consequently, they believe that the entity has a present obligation for future profit sharing that will be payable when the asset or liability is recovered or settled (ie when the temporary differences are included in taxable profits).
22. Those that hold this view calculate the deferred component by applying a measurement approach that is similar to the accounting for deferred taxes in accordance with IAS 12 *Income Taxes*.

***Example***

23. The current and deferred components of the employee benefit are shown in the following example.
  - (a) Assume that an entity has accounting profit of CU1,000 including accrued interest income of CU100.
  - (b) In accordance with tax law, assume that interest income is included in taxable profit when the cash is received.
  - (c) Income tax is levied at 30 per cent of taxable profit, and the law prescribes that the employee profit-sharing arrangement is determined at 10 per cent of taxable profit.
  - (d) In accordance with IAS 12, an entity recognises a current tax liability of CU270  $((1,000-100)*30\%)$  and a deferred tax liability of CU30  $(100*30\%)$ .

- (e) In accordance with IAS 19, the entity will also recognise a liability of CU90  $((1,000-100)*10\%)$ , reflecting the current component of the employee benefit liability.
  - (f) However the issue arises as to whether the entity should recognise an additional liability of CU10  $(100*10\%)$ , reflecting the deferred component of the employee benefit liability.
24. In applying IAS 19 to this situation, the request has identified the following two views:
- (a) **View 1** – the deferred component of the employee benefit liability should be recognised, and calculated in accordance with the IAS 19 guidance for other long-term employee benefits.
  - (b) **View 2** – the deferred component of the employee benefit liability should **not** be recognised.
25. In addition, the staff have identified a third view:
- (c) **View 3** – the deferred component of the employee benefit liability should be recognised and calculated in accordance with **IAS 12**.

***View 1 – the deferred component of the employee benefit liability should be recognised in accordance with IAS 19***

26. Proponents of View 1 believe that the deferred component of the employee benefit liability should be recognised in accordance with IAS 19. Their views are supported by analogy with the requirements of IAS 12.
27. Specifically, they observe the following similarities with income tax, noting that the Mexican employee profit-sharing arrangement is:
- (a) compulsory and determined in accordance with rules established by law;
  - (b) applicable to all business enterprises in all industries (subject to the limited exemptions identified above);

- (c) from the perspective of the entity, calculated based on taxable profit<sup>3</sup> and not affected by the services that an entity receives from individual employees; and
- (d) not a deductible expense in the computation of taxable profit<sup>4</sup>.

*Recognition of the deferred component*

- 28. Proponents of this view think that the deferred component meets the recognition criteria of IAS 19.17.
- 29. IAS 19.17 states:

An entity shall recognise the expected cost of profit-sharing and bonus payments under paragraph 10 when, and only when:

- (a) the entity has **a present legal** or constructive **obligation** to make such payments as a result of past events; and
- (b) **a reliable estimate** of the obligation can be made.

A present obligation exists when, and only when, the entity has no realistic alternative but to make the payments. [emphasis added]

- 30. Proponents of this view argue that an entity has a legal obligation, because of the statutory nature of the Mexican employee profit-sharing arrangement, to pay the deferred component to employees in the future as a result of temporary differences existing at the end of the reporting period. The entity may only be released from the obligation if the law changes or if the entity ceases to have employees in future.

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<sup>3</sup> We were told that many Mexican entities view the employee profit-sharing arrangement as an additional income tax for their business.

<sup>4</sup> To be accurate, a portion of the employee profit-sharing may be deductible if the total amount of compensation paid in a year, including other benefits paid to employees, does not exceed a ceiling established under tax law. However, most entities in Mexico do not have the deductible portion because other benefits exceed the ceiling.

31. They also note that a reliable estimate of the obligation can be made, because income tax law and labour law provide details of what is included and what is excluded in computing taxable profit for the purpose of statutory employee profit sharing. This provides the same level of reliability as the one that IAS 12 requires in the measurement of deferred tax assets and liabilities.
32. Proponents of this view argue that, even though some individuals who exist at the reporting date will leave the entity in future without receiving a share of the deferred component, the entity still has an obligation to pay that share to other employees who exist when the deferred component reverses. They therefore believe that the deferred component is an unavoidable obligation of the entity in the current reporting period.

*Measurement of the deferred component*

33. Proponents of this view believe that an approach analogous to IAS 12 should be used to measure the deferred component.
34. They observe that IAS 19 does not provide detailed application guidance on how to compute the expected future payment attributable to the temporary differences at the reporting date.
35. In the absence of detailed application guidance in IAS 19, supporters of View 1 believe that it is appropriate to consider IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. IAS 8.10 states:

In the absence of an IFRS that specifically applies to a transaction, other event or condition, management shall **use its judgement** in developing and applying an accounting policy that results in information that is:

- (a) relevant to the economic decision-making needs of users;  
and
- (b) reliable, in that the financial statements:
  - (i) represent faithfully the financial position, financial performance and cash flows of the entity;
  - (ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;
  - (iii) are neutral, ie free from bias;



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- (iv) are prudent; and
  - (v) are complete in all material respects. [emphasis added]
36. IAS 8.11 and IAS 8.12 require an entity to consider, in making the judgement, among other things, the requirements in other IFRSs dealing with similar and related issues and the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards.
37. Because of the similarities mentioned above, View 1 proponents argue that IAS 12 deals with issues similar to the Mexican employee profit-sharing arrangement.
38. By applying the measurement approach in IAS 12, the deferred component is measured at statutory rates that are enacted, or substantively enacted, by the end of the reporting period and are expected to apply to the period when the related asset is realised or the related liability is settled (ie when temporary differences are included in taxable profit).
39. In a similar way as with the measurement of deferred tax assets and liabilities in accordance with IAS 12.53, the deferred component is not discounted to reflect the time value of money.

### *Presentation*

40. Under this view, the expenses relating to both the current component and the deferred component of the employee profit-sharing arrangement is presented as an operating expense in profit or loss. This is because the nature of the statutory profit-sharing expense is an employee benefit rather than income tax.

### *Other considerations*

41. The staff understand that View 1 is consistent with the approach applied in accounting for employee profit-sharing arrangements in accordance with other GAAPs.
42. For Mexican GAAP purposes, effective from 1 January 2008, the deferred component is required to be accounted for using the balance sheet approach. This approach is consistent with how IAS 12 measures deferred tax.

43. Mexican accounting for income taxes previously required using the accrual method, a method similar to the timing difference approach for the employee profit-sharing arrangement. It also required presentation of the statutory profit sharing expense, together with income tax, in the income tax section of profit or loss. However, that guidance has been amended, and now requires presenting the statutory profit-sharing expense as operating expense, in accordance with the Mexican accounting standard for employee benefits<sup>5</sup>.
44. In addition, the issue has been discussed in the context of US GAAP. In 1996, the AICPA International Practice Issue Task Force determined that, beginning on 1 January 1997, all registrants are expected to recognise the deferred component using the balance sheet approach<sup>6</sup>.
45. This statutory employee profit-sharing expense is, in conformity with the current guidance in Mexican GAAP, presented as an operating expense in profit or loss under the US GAAP practice.
46. Although this US GAAP treatment is not based on authoritative literature, the staff understand that View 1 provides accounting treatment for the Mexican employee profit-sharing arrangement that is convergent with existing US GAAP practice.

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<sup>5</sup> The amendment was made based on the outreach activities carried on by the Mexican accounting standard-setter. The result of the outreach activities indicated that the statutory employee profit-sharing arrangement was generally accepted in Mexico as an employee benefit and not as an additional income tax.

<sup>6</sup> AICPA International Practice Issue Task Force Meeting Highlights (December 21, 1996). The highlights do not represent an official view of either AICPA or FASB. Also, they are not an authoritative interpretation by the SEC or its staff. But practice generally follows the guidance in the Highlights in the absence of authoritative guidance. The basis for conclusion of the consensus made by the AICPA International Practice Issue Task Force is not publicly available.

***View 2 – the deferred employee profit-sharing should not be recognised in accordance with IAS 19***

47. Proponents of View 2 believe that the deferred component of the employee benefit liability should not be recognised in accordance with IAS 19. Their views are supported by an opinion that the employee profit-sharing arrangement is different in nature from income tax.
48. Specifically, they note the following differences from income tax, noting that the Mexican employee profit-sharing arrangement is:
- (a) a payment made to individual employees, not to the government;
  - (b) a payment made in return for services provided by the employees, not for public services provided by the government;
  - (c) from the perspective of employees, calculated based on how much service the individual provided (ie the number of working days and the amount of salary)<sup>7</sup>, and
  - (d) not computed exactly in the same way as taxable profit. In addition to potential exceptions in the calculation of taxable profit (noted earlier), loss carryforward is not permitted for statutory employee profit-sharing arrangements.

*Recognition of the deferred component*

49. Proponents of View 2 argue that, in accordance with IAS 19, a present obligation does not exist for the deferred component.

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<sup>7</sup> We were told that workers in Mexico generally think of the statutory profit-sharing arrangement as being a part of their compensation package. Their compensation package generally includes salaries (paid over 12 months equally), bonus (the minimum 15 days salary paid before 20 December) and the statutory profit-sharing (paid in May following a tax return filing by the end of March).

50. The statutory employee profit-sharing is a payment in exchange for employee's service, and has a direct link with services the entity receives from its employees. Supporters of this view argue that the deferred component will be shared not only with employees who served during the current reporting period, but also with employees who will join the entity in future reporting periods. This implies that the deferred component is compensation for employee services to be provided in that future reporting period.
51. According to IAS 19.10 and IAS 19.128, liabilities for employee benefits should be recognised to the extent of employee services in current and prior periods. A liability is not recognised for employee services to be provided in future periods.
52. If it is determined that a liability should be recognised for the deferred component, because it is considered to reflect an unavoidable obligation, some argue that a prepayment should also be recognised to reflect the future service the employees will provide to the entity.

*Measurement of the deferred component*

53. Because a liability for the deferred component is not recognised under View 2, there is no need to consider how the deferred component should be measured.
54. However, proponents of View 2 also have concerns about the measurement approach proposed in View 1.
55. Specifically, they identify that the measurement requirements of IAS 19 are in conflict with those in IAS 12. For example, IAS 12.53 prohibits discounting deferred tax assets and liabilities, while IAS 19.128 requires a present value computation that includes discounting for other long-term employee benefits, which would include the deferred component of the statutory employee profit-sharing arrangement, if the recognition criteria are considered to have been met.
56. This conflict in measurement requirements is another reason why proponents of View 2 argue that applying the measurement approach under IAS 12 to an employee benefit arrangement is not appropriate.

*Presentation*

57. Under this view, the statutory profit-sharing expense relating to the current component is presented as operating expense in profit or loss. This is because the nature of the statutory profit-sharing expense is an employee benefit rather than an income tax.

*Other considerations*

58. View 2 supporters are also concerned about the potential implications of View 1 on the accounting for other employee profit-sharing arrangements.
59. They observe other profit sharing arrangements that base their computation on a basis that is different to the amounts that are reported in accordance with IFRSs.
60. This includes arrangements using measurements such as net income reported in accordance with local GAAP or entity-specific key performance indicators reported in accordance with management's internal reporting. However the staff are not aware of any existing or emerging practice of recognising any deferred component in these situations relating to differences between the basis used for purposes of calculating the amount of profit to be shared, and amounts reported in accordance with IFRSs.
61. Proponents of this view argue there is no reason to recognise and measure an employee profit-sharing arrangements based on a taxable profit differently from an employee profit-sharing arrangement based on an income measurement that is not calculated in accordance with IFRSs.
62. They believe that if a liability is to be recognised for the deferred component, IAS 19 should be clarified to require recognising the effect of differences relating to other employee profit-sharing arrangements that are based on a measurement that is not calculated in accordance with IFRSs.

**View 3 – the deferred component of the employee benefit liability should be recognised in accordance with IAS 12.**

63. Although not specifically included in the request, the staff have identified a third view. View 3 is based on a view that the Mexican employee profit-sharing arrangements are, in substance, an income tax, and should be recognised and measured in accordance with IAS 12.

*Recognition of the deferred component*

64. IAS 12.2 states:

For the purposes of this Standard, income taxes include all domestic and foreign taxes which are **based on taxable profits**. Income taxes also include taxes, such as withholding taxes, which are payable by a subsidiary, associate or joint venture on distributions to the reporting entity. [emphasis added]

65. IAS 12.5 defines:

*Taxable profit (tax loss)* is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).

66. The Committee confirmed in March 2006 that the term ‘taxable profit’ implies a notion of a net rather than a gross amount<sup>8</sup>.
67. The Mexican employee profit-sharing arrangement shares this characteristic of income taxes, because it is imposed based on taxable profit, that is, a net amount calculated in accordance with the principles of income tax law in Mexico.
68. The question then arises as to whether the Mexican employee profit-sharing arrangement is a tax, even though it is not paid to the government<sup>9</sup>.
69. Supporters of View 3 believe that the Mexican employee profit-sharing arrangement is, in substance, a tax. It should be considered to be a collection of income tax by the government, followed by the redistribution of income to workers by the government.

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<sup>8</sup> IFRIC Update (March 2006)

<sup>9</sup> Tax is money that you have to pay to the government so that it can pay for public services. (Oxford Advanced Learner’s Dictionary)

70. If statutory profit-sharing arrangements are included within the definition of income, then the deferred component is recognised in accordance with IAS 12, not IAS 19.
71. If IAS 12 is applied directly to the Mexican employee profit-sharing arrangement, the measurement for the current component should also be based on IAS 12. The staff do not see a substantial difference in the measurement of the current portion if IAS 12 is applied because, as in the case of IAS 19.10, IAS 12.46 also requires measuring current tax at the amount **expected to be paid** to the tax authorities.

*Measurement of the deferred component*

72. In accordance with IAS 12.47, the deferred component should be measured at a statutory rate that is expected to apply to the period when the asset is realised or the liability is settled (consequently, when temporary differences that affect the employee profit-sharing calculation are included in taxable profit), based on a statutory rate that has been enacted, or substantively enacted, by the end of the reporting period.
73. In accordance with View 3, the deferred component for the statutory employee profit-sharing arrangements would not be discounted to reflect the time value of money.

*Presentation*

74. Under this view, the statutory profit-sharing expense relating to both the current component and the deferred component is presented in profit or loss as income taxes. This is because the nature of expense is income tax rather than employee benefit.

*Other considerations*

75. As mentioned in paragraphs 44-46 above regarding View 1, practice under US GAAP uses the analogy to ASC Topic 740 *Income Taxes* when accounting for the recognition and the measurement of the Mexican employee profit-sharing arrangement. The staff think that View 3 will prevent divergence from the recognition and measurement requirements adopted in US GAAP practice.
76. However, View 3 would result in a different presentation of the statutory employee profit-sharing expense in profit or loss, because practice presents it as operating expense for US GAAP purposes.

**Staff recommendation**

77. In forming a staff recommendation, the staff considered the nature of the Mexican employee profit-sharing arrangement.
78. IFRSs use various models to account for different types of liabilities. The staff think the question of which model should be used, and thus which of the views above (View 1, 2 or 3) is appropriate, is determined from the viewpoint of whether the statutory employee profit-sharing arrangement is more akin to:
- (a) income tax; or
  - (b) an employee benefit.
79. If the statutory employee profit-sharing arrangement is more akin to an employee benefit than to income tax, then the IAS 19 model should be used to recognise and measure the liability for it. Conversely, if it is more akin to income tax, a liability for it should be recognised and measured using the IAS 12 model.

***Statutory employee profit-sharing arrangement is akin to an income tax***

80. Under this view, which is consistent with View 3:
- (a) the Mexican employee profit-sharing arrangement is, in substance, income tax, and



- (b) a present obligation exists for the deferred component, and this obligation is recognised in accordance with IAS 12.

81. The staff think that applying IAS 12 to the Mexican employee profit-sharing arrangement is not appropriate, and they do not recommend adopting this view, because:

- (a) the Mexican employee profit sharing is paid to employees, not to the government, and
- (b) it is different in nature from income tax, because, from an employee's view point, it has a direct linkage with service provided. A tax payment is a payment for public services and generally does not have a direct linkage with a receipt of the service.

82. If, however, the Committee think that the Mexican employee profit-sharing arrangement is more akin to an income tax than to an employee benefit, the staff think that the Committee should consider:

- (a) recommending that the Board should consider addressing the definition of income tax in the *Income Tax* project in relation to this issue; or
- (b) issuing an interpretation supporting the application of IAS 12 to a statutory employee profit-sharing arrangement that is based on taxable profit.

***Statutory employee profit-sharing arrangement is akin to an employee benefit***

*Deferred component is recognised*

83. Under this view, which is consistent with View 1:

- (a) the Mexican employee profit-sharing arrangement is more akin to an employee benefit than to an income tax; and
- (b) a present obligation exists for the deferred component, and it is recognised in accordance with IAS 19.

84. The staff do not recommend taking this view, because:

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- (a) the staff think that IAS 19.17 should be applied only when the requirements to recognise a liability under IAS 19.10 are met. IAS 19.10 deals with a short-term employee benefit, not with a long-term employee benefit<sup>10</sup>.
- (b) A liability for other long-term employee benefits is not recognised in accordance with IAS 19.128, because IAS 19.7 requires that the present value of the defined benefit obligation does not take into account a payment for employee service in future periods.

The staff think that the deferred component is for employee service to be provided in future reporting periods because the payment to individual employees is determined based on their number of working days and salaries in those future periods.

85. If, however, the Committee thinks that the statutory profit-sharing:

- (a) is more akin to an employee benefit than to income tax; and
- (b) creates a present obligation for the deferred component;

the staff think that recognition of a liability should be based on IAS 19.18 rather than IAS 19.128.

86. IAS 19.18 states:

Under some profit-sharing plans, employees receive a share of the profit only if they remain with the entity for a specified period. Such plans create a constructive obligation as employees render service that increases the amount to be paid if they remain in service until the end of the specified period. The measurement of such constructive obligations reflects the possibility that some employees may leave without receiving profit-sharing payments.

87. Under this view, the service is considered to be have been provided in the current, rather than a future reporting period by the:

- (a) employees as a group, rather than as individuals; and

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<sup>10</sup> In accordance with IAS 19.10, a liability is only recognised when an employee has rendered service to an entity. However, the employee service would not have been rendered for the deferred component of the statutory employee profit-sharing arrangement even if it were a short-term employee benefit.

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- (b) contribution to current period IFRS accounting profit, rather than future period taxable profit.
88. The staff think that the use of a measurement approach based on IAS 12 is not appropriate under this view, because of the differences between the:
- (a) nature of income tax and the Mexican employee profit-sharing arrangement; and
  - (b) measurement approach in IAS 12 and that in IAS 19.
89. For example, IAS 12 prohibits discounting deferred tax assets and liabilities, while IAS 19 requires a present value computation for other long-term employee benefits.
90. Also, if the deferred component arises as an asset, rather than as a liability, because of the existence of deductible temporary differences, the question may arise as to what that asset represents. The asset may be an entity's right to claim a refund of employee benefit already paid, or a right to reduce employee benefit in future, but such rights could possibly conflict with the requirements under labour law.
91. The staff think that if a liability is recognised in accordance with IAS 19.18, it should be measured at the present value of the defined benefit obligation according to IAS 19.22 and IAS 19.128, taking into account the timing and the amount of future settlement of the deferred component.
92. If the Committee thinks it appropriate to take this view, the staff think that the Committee could consider clarifying that a service is provided when a group of employees have contributed to current period accounting profit.
93. This also includes consideration of the accounting for other employee benefit plans that base their computation on an income measurement that is not calculated in accordance with IFRSs.

*Deferred component is not recognised*

94. Under this view, which is consistent with View 2:
- (a) the Mexican employee profit-sharing arrangement is more akin to an employee benefit than to an income tax; and
  - (b) a present obligation does not exist for the deferred component and cannot be recognised in accordance with IAS 19.
95. The staff believe that this view is consistent with current IFRSs, because:
- (a) IAS 19 requires recognition of a liability only when employee service is provided in a current or previous reporting period.  
  
The deferred component is for employee service to be provided in future periods, because temporary differences related to the deferred component will be included in future taxable profit and will be paid to employees who will work during the future reporting periods; and
  - (b) if a liability is recognised, for a future service to be recognised as an asset there should also be a prepayment. Taking View 2 will result in the same net position in the statement of financial position because, under View 2, a liability for the deferred component is in effect offset by the prepayment.
96. If the Committee agrees with the staff recommendation of applying View 2, it needs neither to issue an interpretation nor to recommend that the Board should amend IFRSs because the staff think that IAS 19 is clear that Mexican employee profit-sharing arrangements are within its scope, and that it is also clear that a liability for a payment for future services cannot be recognised.
97. The staff noted that potential diversity with practice under US GAAP would arise if we took View 2, but they also noted that the current US GAAP practice is not based on any authoritative literature, or on official guidance issued by the FASB, the AICPA or the SEC.

**Agenda criteria assessment for the Committee (TBC)**

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

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

Yes. It applies to all business enterprises in a jurisdiction, regardless of size, industry or form of entity. At least two jurisdictions are identified as countries having the same issue: Peru and Mexico. The monetary impact is 10 per cent of taxable profit which generally has practical relevance.

(b) *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The Committee will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

No. The issue is clear under IFRSs and there is no significantly divergent interpretations existing in practice.

Some have expressed their concerns because of the different accounting treatment under US GAAP practice and the Mexican accounting standard. If the Committee clarifies this in an agenda decision, the staff do not expect significant divergent interpretation emerging in practice.

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

Yes. The staff believe that financial reporting would be improved through elimination of the diverse views.

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

It depends upon the Committee's decision on the staff recommendation.

If the Committee agrees with the staff recommendation to take View 2, or prefers to issue an interpretation under View 3, the answer is Yes.

However, if the Committee prefers to amend IFRSs in accordance with View 1 or View 3, the answer is No.

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

Not certain.

## IASB Staff paper

The key issue is whether the Mexican employee profit-sharing arrangement is more akin to income tax or to an employee benefit. Views on this may differ among the Committee members, because the scheme is seen as an additional income tax from the entity's viewpoint, but is seen as a part of compensation from the worker's viewpoint.

- (f) *If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The Committee will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the Committee requires to complete its due process.*

Not applicable.

Neither the Pension project nor the Income Tax project currently expects to address accounting for Mexican employee profit-sharing arrangements.

### Question to the Committee

99. The staff would like to put the following questions to the Committee:

#### Questions for the Committee

1. Does the Committee agree with the staff recommendation not to add this issue to the agenda? If not, how does the Committee recommend the staff to proceed?
2. Does the Committee have any comments on the proposed wording for the tentative agenda decision in Appendix A?

## Appendix A – Proposed wording for agenda decision

- A1. The tentative agenda decision below is proposed if the Committee support the staff recommendation in the agenda paper.

**IAS 19 *Employee Benefits* – Accounting for statutory employee profit-sharing arrangement**

The Committee received a request for clarification relating to whether a deferred profit-sharing liability should be recognised for temporary differences similarly to deferred tax liability in accordance with IAS 12, if the profit sharing in Mexico is statutory and is calculated on the same basis as taxable profit for income tax purposes.

The Committee noted that although the Mexican statutory profit-sharing arrangement is calculated based on taxable profit, it is in nature an employee benefit, not an income tax, because it is a payment in return for employee service.

The Committee concluded that the current IAS 19 does not require recognising a deferred profit-sharing liability for future services at the reporting date.

Consequently, the Committee [decided] not to add this issue to its agenda.

## Appendix B – Agenda request

B1. The staff received the following IFRIC agenda request. All the information has been copied without modification by the staff, except for details that would identify the submitter of the request.

### **COMMITTEE POTENTIAL AGENDA ITEM REQUEST**

#### **Background of the Mexican compulsory employee profit-sharing**

Following is a brief overview of how the compulsory profit-sharing works in Mexico. For many years the workers unions have had a significant political weight in México; back in 1969 a coalition of these unions negotiated with the Mexican Government to establish a compulsory employee profit-sharing to be paid by all the businesses to their employees. As a result, an amendment to the Federal Labor Law passed rapidly through the Congress and was enacted.

This law establishes that all the businesses must pay an employee profit-sharing which is computed on the basis of the taxable income for employee profit-sharing purposes, which is the same than for income tax purposes, except that some deductions allowed by the income tax law are not allowed for employee profit sharing. However, at the end both computations are made applying a percentage on a similar taxable basis and most of the Mexican businessmen have seen the compulsory employee profit-sharing as an additional income tax, since it is not tied to productivity measures or objectives. Furthermore, it is not deductible for income tax purposes, unless exceptional circumstances are met on which a portion may be deductible.

Therefore, an entity has to write two checks based on a similar taxable income every year. One, amounting to 30% of the taxable income, goes to the IRS as income tax and the other, amounting to 10% of the taxable income, goes to the employees as compulsory employee profit sharing.

#### **Recognition of the compulsory employee profit sharing under Mexican Financial Reporting Standards**

As taxable income is different from book income, differences arise due to permanent and temporary differences, and the Mexican Financial Reporting Standards required since 1987 that the compulsory deferred employee profit-sharing be recognized. The method adopted at that time to recognize the deferred compulsory employee profit-sharing was the accrual method, recognizing the effect of the timing differences of the year, provided that these would reverse in the foreseeable future. This led to not recognizing the deferred obligation in many cases.

Starting in 2008, the use of the accrual method was discontinued in order to recognize the deferred compulsory employee profit-sharing effect based on the temporary differences arising between book and tax value of the assets and liabilities, using the same methodology used to recognize deferred income tax since 1987. In this way the Mexican Financial Reporting Standards converged with the point of view stated by the



SEC in the International Financial Reporting and Disclosure Issues in the Division of Corporate Finance, issued on November 1, 2004 that indicated:

*“Prior to issuance of Bulletin D-4 in México, effective January 1, 2000, two methodologies for accounting for deferred profit sharing were in use in Mexico. Some registrants use an accrual methodology and others use a balance sheet methodology. Under the accrual methodology, a liability is recognized for deferred employee profit sharing purposes on timing differences between income for financial reporting purposes and income for purposes of computing the current amount of the employee profit sharing payment. The balance sheet methodology determines the liability based on the difference between assets and liabilities in the financial statements and assets and liabilities determined in accordance with the law relating to the employees profit sharing. This methodology is conceptually consistent with FAS 109.*

*For US GAAP purposes, beginning January 1, 1997, all registrants should calculate deferred employee profit sharing plan obligations using the balance sheet methodology. It would be inappropriate for a registrant to change from the balance sheet methodology to the accrual methodology.*

*Bulletin D-4 (effective January 1, 2000) requires the accrual methodology. As a result, a US GAAP reconciling item is necessary to report the effects of the use of a balance sheet methodology. Profit sharing expense should be classified as an operating expense for purposes of the US GAAP reconciliation.”*

The last sentence of the SEC point of view addressed the fact that the compulsory employee profit sharing was presented in the statement of income together with the income tax.

In 2008, the CINIF decided to take out of the income tax standard the paragraphs dealing with recognition of compulsory employee profit-sharing and include them in the employee benefits standard, using the same methodology for recognizing the compulsory deferred employee profit-sharing than the one for deferred income tax. Also, it required the presentation of profit-sharing for the year in operating expenses or alternatively in other income and expense. The deferred portion should be recognized in other income or expense. Therefore, the classification of compulsory employee profit-sharing in the income tax section was discontinued.

### **Recognition of deferred compulsory employee profit sharing under IFRS**

Now the question arises if deferred employee compulsory profit-sharing has to be recognized under IFRS's. We believe that it should be recognized based on the principle stated in paragraph 17 of IAS 19, which states that:

*“An entity shall recognize the expected cost of profit-sharing and bonus payments under paragraph 10 when, and only when:*

- a) the entity has a legal or constructive obligation to make such payments as a result of past events; and*
- b) a reliable estimate of the obligation can be made.*

*A present obligation exists when, and only when, the entity has no realistic alternative but to make the payments.”*

For the Mexican compulsory employee profit-sharing there is a legal obligation to pay the deferred amounts, unless there is a change in the law or the entity ceases having

employees, which is not probable to occur and if it occurs, such fact would be recognized in the corresponding period. Also, a reliable estimate of the obligation can be made, since the income tax law, on which the compulsory employee profit sharing is computed, defines very precisely the taxable and deductible amounts. The deferred compulsory employee profit-sharing will be paid to the employees working at the entity in the year the deferred amount reverses, even and when these employees are not the same that worked in the year it was generated.

Some entities opposed to recognizing the deferred compulsory employee profit-sharing sustain there is nothing in IAS 19 indicating that a deferred profit-sharing should be computed on the same basis as deferred income tax, based on IAS 12. However IAS 19 does not states that a deferred compulsory employee profit-sharing should not be determined under such basis and we believe that being computed basically as an income tax, it is the only way to determine the related obligation, which results from past events.

We understand that an IFRS cannot contemplate all the different transactions or events in every country where it has to be applied, and to that respect IAS 8 indicates in its paragraph 10, regarding the selection of accounting policies:

*“In the absence of an IFRS that specifically applies to a transaction other event or condition, management should use its judgment in developing and applying an accounting policy that results in information that is:*

- a) relevant to the economic decision-making needs of users; and*
- b) reliable, in that the financial statements:*
  - i) represent faithfully the financial position, financial performance and cash flows of the entity;*
  - ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;*
  - iii) are neutral, ie free from bias;*
  - iv) are prudent; and*
  - v) are complete in all material respects.”*

Therefore judgment has to be used to determine information that is relevant and reliable. Regarding the use of judgment, paragraph 11 of IAS 8, indicates that:

*“In making the judgment described in paragraph 10, management shall refer to and consider the applicability of, the following sources in descending order:*

- a) the requirements in IFRS dealing with similar and related issues; and*
- b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework.”*

We believe that the requirement in IFRS dealing with similar and related issues to a compulsory employee profit-sharing is contained in IAS 12, inasmuch as such profit-sharing is determined on a taxable income that is calculated based on the income tax law. Therefore, in the absence of a specific requirement in IAS 19, there is another IFRS that addresses a similar and related issue. Our assumption is similar to the one of the SEC, which indicates that computing employee profit sharing based on the balance sheet methodology is consistent with FAS 109.

Furthermore, regarding the judgment that has to be made by management, IAS 8 also indicates that:

*“In making the judgment described in paragraph 10, management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices, to the extent that these do not conflict with the sources in paragraph 11”*

As we indicated above, the Mexican Financial Reporting Standards, whose conceptual framework is similar to the one of the IFRS, require that the deferred employee profit-sharing be recognized on a basis similar to that established to recognize deferred income tax by IAS 12. This requirement in the Mexican standards was subject to a due process similar to the one followed by the IASB. The requirement was subject to exposure in 1999, as part of the changes to the standard on income tax, and in 2006 and 2007 when the issues related to employee profit sharing were moved from the standard on income tax to the standard on employee benefits, which is the one dealing with compulsory employee profit-sharing.

Therefore we understand that management may consider the standard issued by the Mexican standard-setting body and may not consider it only if the information in its financial statements would not be relevant and reliable, which would not be the case.

Another assumption used by those opposing the recognition of the compulsory deferred employee profit-sharing is the fact that if an employee leaves the entity, it will not be paid the deferred compulsory employee profit-sharing reversing in future years. It is true that such an employee is, de facto, forgiving such payment, but such forgiveness is not for the benefit of the entity, but to all the employees working in the fiscal year when the temporary items reverse. Therefore, we believe this is not a valid reason for not recognizing the deferred compulsory employee profit-sharing.

#### **Our request**

Therefore XXXXX believes that there is a deferred compulsory employee profit sharing that must be recognized due to the peculiarities of the Mexican employee profit-sharing scheme and we would appreciate IASB confirming our view point that in this case the selection and application of principles specifically applicable to the deferred employee profit sharing is the one contained in paragraphs 10 to 12 of IAS 8, as we indicated above. We understand that the confirmation of this interpretation has to be made by the IFRS Interpretations Committee and we ask you to submit this request to them, however, we consider your opinion as highly valuable.

We would like to emphasize that an answer is urgent as far as three Mexican public entities have announced that they will early apply IFRS in 2010. In their press releases one has indicated that they will eliminate the recognition of the deferred compulsory employee profit-sharing obligation as there is nothing in the IFRS requiring it to be recognized, a second entity has indicated that they are still evaluating the issue and the third one does not indicate anything yet to that respect.