



## **Project update: accounting for pensions**

### ***Discussion Summary 30 June 2006***

#### **1 Introduction**

1.1 This paper provides a project update (as at 30 June 2006) on the ASB's research project on accounting for pensions. It is intended that the project will also address the accounting for other benefits that are payable after the completion of employment, such as the provision of medical care during retirement.

1.2 ASB staff contacts are:

Hans Nailor – Project Director  
([h.nailor@frc-asb.org.uk](mailto:h.nailor@frc-asb.org.uk))

Michelle Crisp – Project Director  
([m.crisp@frc-asb.org.uk](mailto:m.crisp@frc-asb.org.uk))

1.3 The European Financial Reporting Advisory Group (EFRAG) and European National Standard-Setters have agreed to work more closely together so as to enable Europe as a whole to participate more fully in the development of global standards. These co-ordinated proactive activities are referred to by the acronym 'PAAinE', which stands for 'Proactive Accounting Activities in Europe'. Accounting for

pensions was selected as a PAAinE project, which the ASB is leading.

1.4 The ASB is being assisted in this project by a Pensions Advisory Panel appointed by the Board and a pan-European Working Group selected by EFRAG.

1.5 This update sets out a summary of issues discussed to date. It should be treated as work-in-progress towards a discussion paper and, accordingly, the views expressed are tentative and may be changed as the project progresses. This discussion summary is not intended to provide a comprehensive discussion of these issues; and some issues arising from the discussions that have been identified for further development are noted in the appendix.

1.6 The ASB is not specifically seeking comments at this stage.

1.7 The ASB has also been reviewing the disclosure requirements for defined benefit schemes in Financial Reporting Standard (FRS) 17 'Retirement Benefits'. On 31 May 2006 it issued an exposure draft setting out proposals to amend FRS 17 and to issue a new Reporting Statement 'Retirement Benefits – Disclosures'. This review is distinct from the wider research project and is focussed on short-term improvements to disclosures, giving particular consideration to the recent changes made in the UK regulatory regime. Accordingly, the

review is not reflected in this summary.

1.8 This discussion summary is organised as follows:

- Status of project. (Section 2)
- Proposed principles and discussion highlights. (Section 3)
- Discussion:
  - Defining the scope. (Section 4)
  - Defining liabilities for pensions and other retirement benefits. (Section 5)
  - Defining assets and liabilities of each entity who may be party to an arrangement. (Section 6)

## 2 Status of project

2.1 The Board decided to adopt a 'back to basics' approach of examining the fundamentals of pensions accounting.

2.2 The discussions to date of the Pensions Advisory Panel and the EFRAG Working Group have focussed on:

- defining the benefits that are within the scope of the project;
- defining the liability that arises from the obligation to deliver benefits;
- defining the assets and liabilities when a separate fund is established; and
- considering whether funds should be consolidated.

2.3 In the initial part of the project we have considered *what* should be reflected in the measurement of liabilities, but not at this stage *how* the measurement should be done. Once the nature of assets and liabilities has been considered, the project will address their measurement and other issues.

2.4 Since an objective of the project is to contribute to the development of principles-based accounting standards on accounting for pensions and other post-retirement benefits, our starting point for much of the analysis is the IASB's Framework. The Framework is, however, currently being revised under a joint project of the IASB and

FASB to develop a common conceptual framework; therefore, our analysis will reflect relatively firm IASB decisions (as evidenced in exposure drafts, IASB Update and website) that would affect the accounting issues under consideration. Of particular relevance are changes proposed to the definitions of assets and liabilities, the emergence of 'stand-ready' obligations in the recognition of liabilities, the reporting entity concept, control criteria for consolidation and the basis for measuring assets and liabilities.

2.5 One effect of this approach is that some of the discussion inevitably relates to a conceptual basis that is a moving target; nevertheless, the project team believes that the new thinking should be reflected and that it would not be sufficient to rely on the old definitions.

### 3 Proposed principles and discussion highlights

3.1 This section sets out the main points in the discussion and provides references to the discussion in the main body of the paper.

#### Defining scope

3.2 The proposed working definition to guide the scope of the project is:

**All forms of benefits receivable by an employee (or the employee's dependants) in exchange for services provided to an employer which the employee has the right to receive after leaving the service of the employer.**

[see Section 4]

#### Defining liabilities

3.3 The following high level principles are necessary for consistency with the Framework:

1. Only present obligations of an entity (ie obligations that exist today, rather than possible obligations) give rise to liabilities.
2. Present obligations should be recognised as liabilities if they can be measured reliably.

[see 5.13]

3.4 The promise of retirement benefits may give rise to:

- legal obligations (on the basis of a contract setting out the rights and obligations of the employing entity and past and present employees), or
- constructive obligations (for example, when there is an established practice of promising benefits to employees every year even though there is no statutory or contractual obligation to do so).

[see 5.17]

3.5 It is suggested that at any point in time the present obligation comprises:

- an obligation to pay benefits relating to *past* service, and
- an obligation 'stand ready' to pay benefits relating to *future* service (this obligation is only an obligation to exchange and so appears to have little or no value).

[see 5.19-5.21]

***Does discretion matter?***

3.6 Two views are discussed [see 5.38 – 5.52]

**Either**

**All expected payments relating to the present obligation should be reflected in its measurement.**

**Or**

**The present obligation should only reflect estimates of future payments that the entity is presently committed (by legal or constructive obligation) to pay.**

***Should possible future changes to benefits be reflected in the liability?***

3.7 Possible future changes to benefits should not be reflected in the measurement of a present obligation. [see 5.53 – 5.61]

***Should future salary increases be reflected in the liability when benefits are linked to future salary growth?***

3.8 One view is that the obligation to re-price the benefits is ‘an obligation to pay benefits relating to *past* service’ and should be reflected in the liability. [see 5.65 – 5.70]

3.9 An alternative view is that the additional obligation that will arise when pensionable salaries are increased in the future is ‘a stand-ready obligation to pay benefits relating to *future* service’ and should not be reflected in the liability. [see 5.71 – 5.76]

3.10 Some would argue for a middle ground, perhaps distinguishing between future inflationary increases in pensionable salaries that the employer has little or no discretion to avoid (which should be reflected in the measurement of the liability) and future increases over which the employer does have discretion (which should not be reflected in the measurement of the liability). [see 5.77 – 5.82]

**Defining the assets and liabilities of each entity who may be party to an arrangement**

3.11 The analysis relies on three principles: [see 6.3]

1. Do liabilities to pay benefits and assets that are held to settle them meet the definitions of liabilities and assets respectively of the employing entity or a ‘separate entity’?
2. If liabilities to pay benefits and/or assets that are held to settle them belong to a separate entity, does the employing entity have other rights and obligations to that entity or employees that meet the definitions of assets and liabilities?
3. If liabilities to pay benefits and/or assets that are held to settle them belong to a separate entity, should they be consolidated by the employing entity? This depends on whether the

**employing entity controls the other entity (using the concept of control as set out in IASB's standards on consolidated financial statements).**

**3.12 If no separate entity is involved, the employing entity is directly responsible for paying the benefits promised to employees. The liability must therefore rest directly with the employing entity. That is irrespective of whether separate assets are held which the entity intends to use to settle the liability, because setting aside a collection of assets does not relieve the entity of its obligation. [see 6.5]**

**3.13 If assets and liabilities are held by a third party, the employing entity has a liability that reflects its obligations to the third party and the employees. [see 6.9]**

**3.14 Many retirement benefit funds (including trust-based pension funds) would appear to be separate entities because:**

- (a) they have a separate legal existence, and**
- (b) the fund's assets are separate from and beyond the direct control of the employing entity, and**
- (c) the fund has a management function of substance.**

[see 6.18]

**3.15 The analysis suggests that:**

- a 'gross' presentation is justified conceptually in the employer's individual financial statements if the fund does not assume the obligation to pay retirement benefits. [see 6.28]**
- a 'net' presentation is justified conceptually in the employer's individual financial statements if the fund assumes the obligation to pay retirement benefits. [see 6.31]**

**3.16 It is proposed that the consolidation issue is approached from the perspective of applying a control test, in the context of the conclusions being reached in the IASB's consolidations project. [see 6.37-6.49]**

## **4 Defining the scope**

4.1 The following working definition has been proposed to guide the scope of the project:

**“All forms of benefits receivable by an employee (or the employee’s dependants) in exchange for services provided to an employer which the employee has the right to receive after leaving the service of the employer.”**

4.2 The Board decided to undertake the research project because of issues that have arisen that concern the accounting for pensions. Although pensions are one of many types of deferred remuneration given in exchange for an employee’s services, they are economically the most significant type. For those reasons the Board wishes to ensure that pensions are the main focus of the project and to avoid addressing too wide a range of issues.

4.3 However, the Board also believes that if the principles of accounting for pensions are appropriate for pensions, they should also be appropriate, in so far as they are applicable, for accounting for other types of benefits which are payable after the completion of employment. Consequently, the scope corresponds to the scope of benefits that fall within the definition of ‘post-employment benefits’ in IAS 19 and includes other benefits such as the provision of medical care during retirement.

4.4 The working definition refers to benefits which the employee has ‘the right to receive’ after leaving the service of the employer rather than, as in the case of the respective definitions of post-employment benefits and retirement benefits in IAS 19 and FRS 17, to benefits ‘that are payable’ after the completion of employment. It has been noted that in some jurisdictions it is not possible to clearly distinguish between deferred benefits given in exchange for services that are payable before or after leaving service. For example, it is possible under new UK pension legislation for an employee to draw benefits from a pension fund whilst remaining in service. It is necessary that, whilst retaining the focus on remuneration that is deferred until after leaving the service of an employer, a definition should be sufficiently flexible that its scope reflects the flexibility of arrangements that give employees the right to receive benefits before or after leaving service.

4.5 It is not intended that the project should address termination benefits, because these are payable in connection with the termination of an employee’s employment rather than in exchange for services rendered by employees. However, severance benefits that an employee has the right to receive on leaving service that relate to past service (ie the right to benefit accrues with service) would come within its scope.

## 5 Defining liabilities for pensions and other retirement benefits

### Background – recognition of liabilities under the Framework

5.1 Pensions and other retirement benefit arrangements typically give rise to obligations to make payments in the future, where both the amount and timing of payments are uncertain.

5.2 Under the Framework, an item should be recognised as a liability if:

- the item meets the definition of a liability; and
- it is probable that a transfer of economic benefits will be required; and
- the item can be measured reliably.

5.3 The following sources are significant to the analysis of pensions obligations:

- liability definition
- definition of legal obligation
- definition of constructive obligation
- emergence of 'stand-ready' obligations

#### *Liability definition*

5.4 The present definition of a liability in the IASB's 'Framework for the Preparation and Presentation

of Financial Statements' (the Framework) 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.”

5.5 Essential characteristics of a liability presently include:

- for an obligation to exist, an entity must have little, if any, discretion to avoid settling it (i.e. there must be a legal or constructive obligation)
- a past transaction or event must have occurred that makes an obligation a present obligation at the financial statement date.

5.6 The IASB has considered the following working definition of a liability in its current review of asset and liability definitions:

“A liability is a present economic obligation of an entity and its characteristics are:

- (a) the entity is obligated to act or perform in a certain way (or refrain from acting or performing);
- (b) the obligation exists at the financial statement date; and
- (c) the obligation is economic – it is an obligation of the entity to provide its economic resources to

others, or to stand ready to do so “<sup>1</sup>

5.7 The IASB and FASB have indicated their intention that the revised definition of a liability should limit liabilities to obligations that have legal or equivalent compulsion. One effect of this refinement would be to replace the notion of ‘little or no discretion to avoid’ with the notion of ‘compulsion’.<sup>2</sup>

#### *Legal obligation*

5.8 IAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’ defines a *legal obligation* as follows:

“A present obligation that arises from the following:

- (a) a contract (through its explicit or implicit terms);
- (b) legislation; or
- (c) other operation of law”

#### *Constructive obligation*

5.9 The current exposure draft<sup>3</sup> of amendments to IAS 37 (July 2005) defines a *constructive obligation* as:

“A present obligation that arises from an entity’s past actions when:

- (a) by an established pattern of past practice, published policies or a sufficiently current statement, the entity has indicated to other

parties that it will accept particular responsibilities; and

- (b) as a result, the entity has created a valid expectation in those parties that they can reasonably rely on it to discharge those responsibilities.”

5.10 The direction of the changes being considered to the definitions of constructive obligations and liabilities is to raise the threshold for determining whether an entity’s past actions have created a constructive obligation that meets the definition of a liability.

#### *Stand-ready obligations*

5.11 The exposure draft of amendments to IAS 37 (July 2005) proposes that contractual rights and obligations can be divided into two types: *conditional* (or contingent) and *unconditional* (or non-contingent). It proposes that liabilities only arise from *unconditional* obligations and that an obligation that is contingent or conditional on the occurrence or non-occurrence of a future event does not by itself give rise to a liability.

5.12 However, the exposure draft also proposes that many possible obligations that have previously been thought of as contingent liabilities do in fact contain unconditional obligations. The unconditional obligation is referred to as ‘stand-ready’ obligation (ie an unconditional obligation to stand ready to fulfil the contingent or conditional obligation *if* the uncertain future event occurs) and gives rise to a liability. The contingency that makes the outcome

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<sup>1</sup> IASB Update April 2006.

<sup>2</sup> IASB Update February 2006.

<sup>3</sup> The exposure draft’s definition is included to provide the most up to date definition; however, it is not very different from the existing IAS 37 definition.

uncertain will then be reflected in the measurement of the liability by assigning probabilities to possible outcomes.

**Recognition of liabilities associated with pensions and other retirement benefits**

5.13 The following high level principles are necessary for consistency with the Framework:

- 1. Only present obligations of an entity (ie obligations that exist today, rather than possible obligations) give rise to liabilities.**
- 2. Present obligations should be recognised as liabilities if they can be measured reliably.**

5.14 The ultimate cost of benefits is usually uncertain and needs to be estimated. All uncertainties about the amount of an entity's present obligations (i.e. the amounts that will eventually be paid to settle them) are reflected in their measurement.

***What are present obligations?***

5.15 A present obligation must have arisen from a past transaction or event.

5.16 The emergence of present obligations may be analysed as follows in the context of the definitions set out above.

5.17 **The promise of retirement benefits may give rise to:**

- legal obligations (on the basis of a contract setting**

**out the rights and obligations of the employing entity and past and present employees), or**

- constructive obligations (for example, when there is an established practice of promising benefits to employees every year even though there is no statutory or contractual obligation to do so).**

5.18 The principle in IAS 19 *Employee Benefits* is that a present obligation is created when an employee renders service in exchange for benefits promised under the plan. IFRS 2 *Share-based Payment* is similar in that, for cash-settled share-based payments that give rise to liabilities, it requires an entity to recognise an expense for services received and liability to pay for those services as employees render service.

5.19 **In the light of the aforementioned emerging proposals for the recognition of liabilities, it could be argued that at any point in time the present obligation comprises two elements:**

- (a) an obligation to pay benefits relating to *past* service;**
- (b) an obligation to 'stand ready' to pay benefits relating to *future* service.**

**In any event it is important to distinguish those obligations.**

5.20 Before the employee renders service, the obligation would be viewed as a 'stand-ready' obligation

to pay benefits relating to *future* service. But since that obligation is only an obligation to exchange (ie the contract is executory) it would appear to have little or no value.

5.21 The rendering of service increases the amount of the liability – in other words, the exchange of services for the right to receive the promised benefits is recognised when the services are provided.

5.22 Obligations to pay benefits relating to *past* service may be either (i) unconditional or (ii) conditional on the outcome of uncertain future events (and may therefore also represent ‘stand-ready’ obligations).

***What future events should be reflected in the measurement of the present obligation?***

5.23 The ultimate cost (i.e. the amount of cash payments that will arise in the future) of benefits that have been earned by employees in respect of their past service may depend on factors such as:

- longevity of employees and their dependants,
- future inflation (when the amount of cash payments that will arise in the future is affected by future inflation in prices),
- whether vesting conditions will be satisfied,
- future changes to benefits that have been earned,

- future changes to contribution rates,
- future pensionable salaries,
- death or ill health
- future medical costs.

5.24 It is necessary to determine which future events should be reflected in the present obligation that exists today and which future events should be recognised as liabilities (and expenses) when they actually occur.

5.25 One approach would be to measure directly the services received in exchange for the promise of retirement benefits. However, retirement benefits are just one component of an employee’s remuneration package and it is not possible to measure reliably the services received for them. This approach has not, therefore, been considered further (the issues are parallel to those considered in IFRS 2 in relation to share-based payments for employee services).

5.26 It is therefore necessary to measure directly the liability. All uncertainties about the amount of an entity’s present obligations (i.e. the amounts that will eventually be paid to settle them) are reflected in their measurement.

5.27 The approach outlined above is considered first in relation to:

- vested benefits
- unvested benefits

- plans with service-entry criteria

5.28 The following 'future events' issues are then considered:

- does discretion matter?
- should possible future changes to benefits be reflected in the liability?
- should future salary increases be reflected in the liability when benefits are linked to future salary growth?

#### *Vested benefits*

5.29 Vested benefits are benefits for which the employee's right to receive benefits in relation to past service are not conditional on remaining in the service of the employer.

5.30 The present obligation is an unconditional obligation to provide benefits to the employee (or dependants) in relation to past service.

5.31 Measurement of the present obligation will reflect all uncertainties about future events that will affect the amounts that will ultimately be paid in respect of vested benefits.

#### *Unvested benefits*

5.32 Unvested benefits are benefits for which the employee's right to receive benefits in relation to past service are conditional on completing a specified period of future service, ie the employee

receives no benefits if he leaves before the end of the specified period.

5.33 The present obligation is an obligation to 'stand ready' to make payments to the employee (or dependants) in respect of past service *if* the employee completes the specified period of service.

5.34 Measurement of the present obligation reflects:

- the probability that the employee will complete the specified period of service; and
- all uncertainties about future events that will affect the amounts that will ultimately be paid in respect of benefits that are expected to vest.

#### *Service-entry criteria*

5.35 In some plans, at an employee's commencement of employment the employee is given the right to join a retirement benefits plan after a qualifying period of service.

5.36 During the qualifying period of service, any present obligation is an obligation to 'stand ready' to provide benefits in exchange for the employee's services if the employee becomes eligible to join the plan.

5.37 If no unvested benefits arise during the qualifying period (ie if there is no 'backlog' of benefits that vest when the employee joins the plan), the present obligation is akin to a 'stand-ready' obligation to pay

benefits relating to *future* service and so has little or no value (see paragraph 5.20 above).

### ***Does discretion matter?***

#### *Issue*

5.38 Some benefits may be viewed as ‘non-discretionary’. Others may be viewed as ‘discretionary’. The distinction sometimes arises in relation to future increases to pensions in payment, pensions in deferment and benefits earned by members in service.

5.39 Benefits referred to as ‘non-discretionary’ include increases that are guaranteed by law or contract. Increases in benefits that are guaranteed because they are linked to future increases in a price index would fall into this category. They would be reflected in the measurement of the liability that exists today.

5.40 ‘Non-discretionary’ benefits also include constructive obligations that may be inferred from past actions, eg when there is an established practice of granting increases every year (and there is every reason to believe such practice will continue) even though there is no statutory or contractual obligation or published policy.

5.41 Benefits referred to as ‘discretionary’ include increases that the entity may choose to pay in the future, but is genuinely not presently committed to paying, ie there is not a legal or constructive obligation to pay them. For example, an entity may have a policy that it will consider making

benefit increases over and above any increases guaranteed in the plan rules and has a past practice of granting increases from time to time when funding conditions were favourable.

***5.42 A fundamental question is whether possible future benefits relating to past service should be reflected in the measurement of the liability if there is not presently a legal or constructive obligation to pay them.***

5.43 If the answer to that question is that it is appropriate to reflect only benefits that the entity is presently legally or constructively obliged to pay, the treatment of benefits that are not guaranteed by law or contract will depend on where the IASB and FASB position themselves on constructive obligations. The present guidance on constructive obligations in IAS 19 is quite permissive. For example, paragraph 52 states: “An example of a constructive obligation is where a change in the entity’s informal practices would cause unacceptable damage to its relationship with employees.” An NAPF Policy Paper *Accounting for Pensions: Pensions accounting in financial statements prepared under International Financial Reporting Standards* (November 2004) notes that in practice constructive obligation has been widely interpreted and future pension increases are usually included even when they are discretionary. Under the proposed definition of a constructive obligation in the current exposure draft of amendments to IAS 37 an entity would have to create a valid

expectation (of increases) that the members should be reasonably able to rely on.

#### *Views*

#### **5.44 Some believe that all expected payments relating to the present obligation should be reflected in its measurement.**

5.45 Under this view, if an employee is owed a pension for, say, ten years' service, the only issue is to estimate how much it will cost. The present obligation is not limited to reflecting estimates of future payments that the entity is *presently* committed (by legal or constructive obligation) to pay.

5.46 Some who hold this view believe that a limiting factor on where the liability ends is reliable measurement. They believe that it may not be possible to measure reliably the amount of cash payments that will arise in the future when they are dependent on future decisions that are at the entity's discretion.

#### **5.47 Others strongly believe that the present obligation should only reflect estimates of future payments that the entity is presently committed (by legal or constructive obligation) to pay.**

5.48 For example, to justify inclusion in the measurement of the present obligation the practice of granting increases to benefits relating to past service would have to meet the definition of a constructive obligation in its own right. If it does not, a second event – say, the announcement of a

discretionary increase – is necessary to confirm a present obligation in respect of the element of benefits that is discretionary. In other words, a liability (and expense) does not arise in respect of discretionary increases until the announcement of an increase.

5.49 Those who take this view also note that in practice it would be necessary to consider carefully all the circumstances because there would be a spectrum of expectations. This ranges from the hope that increases would be paid, through an expectation that they would be paid, to strong grounds for believing that increases would be paid and at some point along that spectrum the expectation would become sufficiently clear for a constructive obligation to exist.

5.50 Some are very concerned that an approach that reflects all expected payments in the measurement of existing liabilities means that the costs associated with decisions taken in future periods are disguised in financial statements because they have been anticipated in earlier periods. In their view this goes against the grain of the recent efforts of accounting standard setters to preclude the recognition of liabilities in respect of future costs when a legal or constructive obligation does not exist. They believe that this approach represents 'profit-smoothing' and is not representationally faithful of the activities of each period.

5.51 Some have advised that discretionary increases to benefits are often granted only if adequate

funding is in place. They believe it would be wrong to reflect as a liability possible increases to benefits that would not be considered unless justified by future investment returns, which are not reflected as assets. On the other hand, a constructive obligation might exist when a scheme was in surplus.

5.52 It has also been noted that past practice and expectations of discretionary benefits are likely to change in response to changing circumstances. Some believe that even if inclusion of discretionary benefits could be justified conceptually, they could not be measured reliably.

***Should possible future changes to benefits be reflected in the liability?***

5.53 A related issue is whether possible future changes to benefits relating to past service should be reflected in the measurement of the present obligation. Examples of the restructuring of benefits include increasing the retirement age, increasing employees' contributions, and closing a scheme in relation to future service.

5.54 A feature that perhaps can help distinguish this issue from the previous discussion of discretionary benefits is that it relates to changes that can only be arrived at after a process of negotiation or consultation concerning the modification of existing contractual terms and conditions.

5.55 Those who believe that the present obligation should only reflect estimates of future payments that the entity is presently committed (by legal or constructive obligation) to pay also believe that the effect of changes to benefits relating to past service should be accounted for as and when they occur.

5.56 They believe that the effects of changes to contractual terms and conditions should be accounted for as and when they occur, because they give rise to different obligations than exist today.

5.57 Under the view that the measurement of the present obligation to pay benefits for past service should reflect expected payments it would be necessary to address whether or not a restructuring of benefits should be viewed as changing the amount required to settle the existing obligation or giving rise to a different obligation.

5.58 The approach taken in IAS 37 would preclude reflecting future events in the measurement of a present obligation unless there is sufficient objective evidence that they will occur. For example, the effects of possible new legislation are not taken into consideration in measuring an existing environmental clean-up obligation until sufficient objective evidence exists that the legislation is virtually certain to be enacted.

5.59 In contrast, the approach taken in the exposure draft of amendments to IAS 37 (2005) is that

if an expected cash flow approach is used appropriately, there is no reason why an entity should not use assumptions about future events that affect the amount required to settle an obligation, regardless of whether there is 'objective evidence' about those events occurring. The exposure draft reasons that in an expected cash flow calculation, the likelihood of those events occurring will be reflected in the probability weighting applied to the cash flows.

5.60 However, the exposure draft also proposes that the effects of future events that create new obligations (or change or discharge existing obligations) are not reflected in the measurement of a liability. For example, the effects of possible new legislation are not reflected in the measurement of a liability because it is reasoned that they give rise to a new obligation (or change an existing obligation) rather than change the amount required to settle the existing obligation.

**5.61 All the various viewpoints point to the conclusion that possible future changes to benefits should not be reflected in the measurement of a present obligation.**

***Should future salary increases be reflected in the liability when benefits are linked to future salary growth?***

5.62 An important decision on what comprises the present obligation at a point in time in a final (or average) salary scheme is whether future salary increases are to be reflected.

The effect of excluding future salary growth is to reduce liabilities and increase future costs. The financial effect of including or not including future salary growth will vary according to the maturity of the scheme.

5.63 Some constituents have argued that the effects of future increases in pensionable salaries should be excluded from the measurement of existing liabilities.

5.64 Standard-setters have previously taken the view that the effects of future increases in pensionable salaries should be reflected in the measurement of services provided to the balance sheet date.

*View that future salary increases should be reflected*

5.65 Present accounting standards set out their basis for the view that future salary increases should be reflected in the measurement of the liability:

IAS 19 (Basis for Conclusions, paragraph 36) states:

"The Board believes that the assumptions are used not to determine whether an obligation exists, but to measure an existing obligation on a basis which provides the most relevant measure of the estimated outflow of resources. If no increase is assumed, this is an implicit assumption that no change will occur and it would be misleading to assume no change if an entity expects a change."

FRS 17 (Appendix IV, paragraph 12):

“The FRS requires the defined benefit liability to be the best estimate of the present value of the amount that will actually be paid out. For this to be the case, all expected changes in factors affecting the payments should be taken into account. For final salary liabilities, the liability will therefore be based on the expected final salary, not the current salary. Some argue that this is not consistent with FRS 12 because the employer has some control over the future increases in salary and hence does not have a present obligation relating to those increases. However, there is a difference between a present commitment to pay a pension based on present salary and a present commitment to pay a pension based on final salary, which the Board believes should be reflected in the measurement of the liabilities.”

FAS 87 (Basis for Conclusions, paragraph 143) states:

“...the Board concluded that estimated future compensation levels should be considered in measuring the service cost component and the projected benefit obligation if the plan’s benefit formula incorporates them. The Board perceives a difference between an employer’s promise to pay a benefit of 1 percent of an employee’s *final* pay and a promise to pay an employee a fixed amount that happens to equal 1 percent of the employee’s *current* pay. Ignoring the future variable (final pay) on which the obligation in the first

case is based would result in not recognising that difference.”

5.66 The thrust of the argument for including the effect of expected future salary increases is that the contractual arrangement as it exists today gives an unconditional promise to the employee that service given over the employee’s career will be priced at the rate of the employee’s final salary. Put simply, if employee A is in a final salary scheme and employee B is in a current salary scheme, the value of the promise to A is different from the value of the promise to B (all things being equal, the value of the promise to A is likely to be greater) and they should not, therefore, be reported at the same liability amounts

**5.67 Under this view the obligation to re-price the benefits is (using the suggested formulation of a present obligation given in paragraph 5.19 above) ‘an obligation to pay benefits relating to past service’.**

5.68 Under this view, the present obligation at any point in time could be analysed as follows:

- part of the pension promise has vested (i.e. the benefit that relates to past service and current salary)
- part of the pension promise has not yet vested (i.e. the re-pricing from current salary to final salary is conditional on completing further service).

5.69 Some would consider the above analysis to be consistent with the suggested analysis of vested and unvested benefits in paragraphs 5.29-5.34 above. In particular, it was suggested that unvested benefits in relation to past service give rise to a present obligation to 'stand-ready' to make payments if the employee completes the specified period of service.

5.70 It has been noted that some have argued that future increases in pensionable salaries should not be reflected in the liability because they are within the entity's control and are therefore (at least to some extent) discretionary. However, those who believe in the current approach consider that the obligation to pay a pension relating to past service is not discretionary – the question of discretion, if it arises, concerns the measurement of the obligation.

*View that future salary increases should not be reflected*

5.71 Others strongly disagree with the current approach. A principal argument is that increases in the value of pension benefits that are associated with future salary increases are rewards for services to be received in the future. An obligation does not therefore exist in relation to services provided.

**5.72 Under this view, the additional obligation that will arise when pensionable salaries are increased in the future is (using the suggested formulation of a present obligation given in paragraph 5.19) 'a stand-ready' obligation to pay**

**benefits relating to future service'** (in contrast to the view that it gives rise to a stand-ready obligation to pay benefits relating to *past* service).

5.73 Employees typically become more expensive as they progress through their careers. In addition to paying higher current benefits as they progress, in a final salary scheme the employer also makes the original pension promise more valuable with each increase in pensionable salary. Some believe that the current approach is inconsistent with the treatment of expected increases in other elements of remuneration – such as salaries and bonuses – which are accounted for in the periods in which they occur. For example, under this view the cost of promoting an employee includes an increase in the value of the employee's pension benefits (that is larger the longer the employee's service). That cost should be reflected as a current service cost relating to the decision to promote the employee, together with increases in other components of the employee's remuneration.

5.74 To counter the argument in 5.66 that the value of the promise to employee A (in a final salary scheme) is likely to be greater than the value of the promise to employee B (in a current salary scheme), some believe that the employer has discretion over the components of a competitive remuneration package. For example, it would be rational to expect employee A's pensionable salary to grow more slowly than employee B's pensionable salary to reflect the greater service cost

associated with each increase in employee A's pensionable salary. Put simply, more of employee A's remuneration for each year is deferred. Reflecting the effect of pensionable salary increases when they occur therefore enhances rather than impairs comparability.

5.75 Some have noted that the effect of future salary increases is not, as a matter of law (in the context of recent pensions legislation in the UK<sup>4</sup>) included in measures of pension liabilities and believe that this is a material new factor was not relevant when the issue was addressed in IAS 19 and FRS 17.

5.76 Those who are concerned about the current approach have similar concerns to those who believe that discretion matters when considering what should be reflected in liabilities. They believe it represents 'profit-smoothing' and disguises the true economic cost of the activities of each period (including the consequences of expensive management decisions). They also believe that making the accounting more transparent should encourage rational decision making. However, others dispute this argument and believe that the current approach properly reflects the cost attributable to each period when considered from the perspective of the workforce as a whole.

*View that some salary inflation should be reflected*

**5.77 Some would argue for a middle ground, perhaps distinguishing between future inflationary increases in pensionable salaries that the employer has little or no discretion to avoid (which should be reflected in the measurement of the liability) and future increases over which the employer does have discretion (which should not be reflected in the measurement of the liability).**

5.78 Increases that the employer has little or no discretion to avoid would include increases that are considered not to be within the entity's control, such as the inflation element of salary increases (which arises from an entity's obligation to review salaries periodically). They might also include increases that usually arise from increasing age or length of service.

5.79 Increases over which the employer has discretion might include increases that are considered to be within the entity's control, such as those related to promotion, merit or productivity. The effect of such increases would be considered to be a cost relating to service of the current period because it represents higher remuneration for the provision of a more valuable service than previously.

5.80 Others believe that it is not possible to distinguish discretionary and non-discretionary elements of expected growth in future pensionable salaries. For example, they would question the validity of

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<sup>4</sup> Pensions Act 2004

including some inflationary salary progression but excluding the effect of promotions, when the reality is that there is an expectation of both during an employee's career.

relevant information about current and expected future obligations.

5.81 Others take the view that reflecting the effect of salary inflation in pension liabilities is not consistent with the treatment of future inflationary (ie non-discretionary) increases in other elements of employees' remuneration, which are usually regarded as a cost of future service (and do not give rise to present obligations).

5.82 In territories such as the UK where there is a statutory obligation to revalue pensions in payment and pensions in deferment (e.g. limited price indexation), it can be argued that employees in service also have a 'right to inflation' attached to their accrued benefits. Employees in effect have an option to leave service at any time and receive a deferred pension that is subject to statutory indexation. It can therefore be argued that this inflation should be reflected in the measurement of the liability even if the view is taken that future salary increases should not be reflected.

#### *Disclosure*

5.83 Some believe that disclosures in financial statements should distinguish measures of liabilities 'with' and 'without' the effect of future salary increases. Whichever measure is required to be reported in the balance sheet, the other measure should be disclosed because both measures provide

## **6 Defining the assets and liabilities of each entity who may be party to an arrangement**

### **Introduction**

6.1 Financial statements contain information about resources controlled by an entity and claims on those resources. What resources and claims are included in and excluded from financial statements is determined by the boundary of the reporting entity, ie the boundary of the individual reporting entity (for an entity's *individual* financial statements) and the boundary of the group (for an entity's *consolidated* financial statements).

6.2 Section 5 considered which obligations to pay benefits should be reflected in liabilities without addressing the question which entity (or entities) should recognise the liability.

### **6.3 The analysis relies on three principles:**

- 1. Do liabilities to pay benefits and assets that are held to settle them meet the definitions of liabilities and assets respectively of the employing entity or a 'separate entity'?**
- 2. If liabilities to pay benefits and/or assets that are held to settle them belong to a separate entity, does the employing entity have other rights and obligations to that entity**

**or employees that meet the definitions of assets and liabilities?**

- 3. If liabilities to pay benefits and/or assets that are held to settle them belong to a separate entity, should they be consolidated by the employing entity? This depends on whether the employing entity controls the other entity (using the concept of control as set out in IASB's standards on consolidated financial statements).**

6.4 Three scenarios are:

- no separate entity is involved (see 6.5 below)
- assets and liabilities are held by third parties (see 6.7 below)
- employer-sponsored funds are involved (see 6.12 below)

### **No separate entity is involved**

**6.5 If no separate entity is involved, the employing entity is directly responsible for paying the benefits promised to employees. The liability must therefore rest directly with the employing entity. That is irrespective of whether separate assets are held which the entity intends to use to settle the liability, because setting aside a collection of assets does not relieve the entity of its obligation.**

6.6 If a fund of assets is established which does not satisfy

the concept of a separate entity (ie it is simply a collection of assets of the employing entity), we would be drawn to the conclusion that:

- (a) the assets held by the fund are reported as assets of the employing entity in its individual financial statements; and
- (b) the obligation to pay retirement benefits to the employee is a liability of the employing entity (ie it is not a liability of any other reporting entity).

**Assets and liabilities are held by third parties**

6.7 The transfer of assets to a third party, to be used to settle a liability, does not necessarily mean that the assets cease to be assets of the transferor.

6.8 However, when an employee has a contract with another entity that provides retirement benefits (for example, a personal pension contract with a life insurance company), it seems clear that the employee has a claim on that entity. Conversely, that entity is under contract with the employee directly responsible for paying the benefits promised to the employee. In those circumstances the liability, together with assets held to satisfy it, belong to the third party.

**6.9 The employing entity has a liability that reflects its obligations to the third party and the employees.**

6.10 For example, if the employing entity has indicated to its employees that it will accept no responsibilities in relation to the arrangement between the employee and the third party entity (except for the obligation to pay contributions), no liabilities arise other than for the obligation to pay contributions for past service.

6.11 If the employing entity has accepted any other responsibilities to its employees that may give rise to legal or constructive obligations, it should reflect those. An example is a guarantee or other obligation to remedy underperformance or default by an employer-chosen pension provider.

**Employer-sponsored funds**

6.12 The main focus will be on the family of arrangements where some form of separate fund (usually a trust or similar entity) is established by the employing entity.<sup>5</sup>

6.13 When a retirement benefit trust (or similar entity) is established by the sponsoring employer, possible representations of assets and liabilities in the employing entity's financial statements are:

- (i) a 'gross' representation – ie the obligations to employees as discussed in Section 5 are reported

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<sup>5</sup> This paper is written in the context of plans that are sponsored by a single employing entity. Multi-employer plans will be considered later in the project.

as liabilities of the employing entity. Separately, the assets held by the fund, or the employing entity's claim on the fund, are reported as assets of the employing entity.

- (ii) a 'net' representation – ie the obligations to employees as discussed in Section 5 are not reported as liabilities of the employing entity. Instead, the employing entity reports an asset or liability that reflects its rights and obligations to the fund (showing the net effect of incurring obligations to employees and investing in fund assets).

6.14 It is necessary to consider these issues in:

- (i) individual financial statements, and
- (ii) consolidated financial statements.

### **Individual financial statements**

6.15 When a fund is established, it is necessary address the following questions:

- (i) Is the fund a separate entity or is it part of the employing entity?
- (ii) If the fund is a separate entity, what assets and liabilities arise in the

employing entity and the fund?

### ***Is the fund a separate entity or is it part of the employing entity?***

6.16 The IASB and FASB have begun to discuss the 'Reporting Entity Concept' as part of the project to converge their conceptual frameworks. One of the IASB's initial conclusions, as reported in *IASB Update* December 2005, was:

"The reporting entity concept should focus on determining the boundaries of the reporting entity, for both an individual reporting entity and a group reporting entity. This is clear from the objectives of financial statements."

6.17 *IASB Update* March 2006 reports:

"The Board decided that an entity for financial reporting purposes should not be limited to legal entities, such as companies, trusts and partnerships. Rather, an entity should be defined more broadly to include other types of organisational structures. This would include a natural person, a sole proprietorship and, in some circumstances, a branch or segment of a legal entity. However, something that is merely a collection of assets and liabilities, without a management or administrative function to manage that collection, is not an entity."

**6.18 Many retirement benefit funds (including trust-based pension funds) would appear to be separate entities because:**

- (a) they have a separate legal existence, and**
- (b) the fund's assets are separate from and beyond the direct control of the employing entity, and**
- (c) the fund has a management function of substance.**

6.19 The establishment of a trust, for example, ensures that the assets of the fund are kept separate from those of the employing entity and are ringfenced against claims by its own creditors. The basis of trust law is that assets are held by trustees for the benefit of the beneficiaries. The principal beneficiaries are the members of the scheme; they comprise both employees of the employing entity and individuals who are not in its employment (ie pensioners, deferred members, and their families or dependants).

6.20 An objective of establishing a trust is to try to ensure that the fund's assets are invested properly, the scheme is administered properly and that members' benefits are safeguarded. Trustees' fiduciary duties oblige them to act in the best interests of beneficiaries – they are supposed to separate their duties and responsibilities as trustees from other roles that they may have, eg responsibilities they may hold in connection with the business of the employer or representing the

interests of particular groups or individuals. Their duties and responsibilities are determined by the trust instrument and reinforced by law.

6.21 It is readily apparent that there are external users who rely on separate financial reports of retirement benefit funds and would not be satisfied to receive financial statements of the employing entity that included financial information about the fund. External users include beneficiaries (pensioners, deferred pensioners, employees) who are concerned about the security of their benefits and the performance of the fund's investments, actuaries (in respect of defined benefit schemes), trustees and regulators.

***If the fund is a separate entity, what assets and liabilities arise in the employing entity?***

6.22 If it is concluded that a fund is a separate reporting entity, that conclusion does not address the question of what exactly are the rights and obligations of the parties involved and, hence, what assets and liabilities arise. For example:

- (a) the employer might have an obligation to pay retirement benefits and, separately, a right to be reimbursed from the retirement benefit fund; or
- (b) the employer might not have an obligation to pay retirement benefits but, instead, have a different obligation to the fund and/or the employees.

6.23 The analysis depends on whether:

- (a) the employer has a direct obligation to pay retirement benefits (see 6.24-6.28 below), or
- (b) the fund has an obligation to pay retirement benefits and the employer has an obligation to support the fund (6.29-6.32 below).

*Employer has direct obligation to pay retirement benefits*

6.24 When the employing entity has the obligation to pay retirement benefits, the assets and liabilities that are representative of the rights and obligations appear to be as follows:

	Assets	Liabilities
<i>Members</i>	Claim against the employing entity for right to receive retirement benefits	
<i>Fund</i>	Assets invested	Obligation to reimburse the employing entity
<i>Employing entity</i>	Right to reimbursement from the fund	Obligation to fund members to pay their retirement benefits

6.25 This treatment is analogous to the accounting treatment for certain

funds that are addressed in IFRIC Interpretation 5 'Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds'. IFRIC 5 addresses decommissioning, etc funds that have both of the following features:

- (a) the assets are administered separately (either by being held in a separate legal entity or as segregated assets within another entity); and
- (b) a contributor's right to access the assets is restricted.

6.26 IFRIC 5 requires that the contributor shall recognise its obligation to pay decommissioning costs as a liability and recognise its interest in the fund separately unless the contributor is not liable to pay decommissioning costs even if the fund fails to pay.

6.27 The reasons given in IFRIC 5 for that requirement include the following points:

- there is no legally enforceable right to set off the rights under the decommissioning fund against the decommissioning liabilities;
- if the fund does not assume the obligation for decommissioning, at best, the fund acts like an in-substance defeasance that does not qualify for derecognition of the liability.

**6.28 The analysis suggests that a ‘gross’ presentation is justified conceptually in the employer’s individual financial statements if the fund does not assume the obligation to pay retirement benefits.**

*Employer has an obligation to support the fund*

6.29 When the fund has an obligation to pay retirement benefits and the employer has an obligation to support the fund, the assets and liabilities that are representative of the rights and obligations appear to be as follows.

	Assets	Liabilities
<i>Members</i>	Claim against the fund for right to receive retirement benefits	
<i>Fund</i>	Assets invested  Right to call for contributions from the employing entity to the extent that the fund’s obligations cannot be met from the fund’s own assets	Obligation to plan members to pay their retirement benefits  <i>Possibly, an obligation to refund the employer to the extent that the plan’s own assets exceed its obligations</i>
<i>Employing entity</i>	<i>Possibly, a right to call for a refund from the fund to the extent that the fund’s own assets exceed its obligations</i>	Obligation to the fund to the extent that the fund’s obligations cannot be met from the fund’s own assets <sup>6</sup>

<sup>6</sup> This may be subject to considering levers available to the employer to mitigate its obligation if there is a shortfall of assets – for example, requiring employees to face reduced benefits or increased contributions.

6.30 This analysis would include the following type of arrangement:

- An employee's contract with the employing entity gives the employee the right to join an employer-sponsored retirement benefits plan.
- By becoming a member of the plan, the employee becomes entitled to receive the benefits provided by the plan.
- The sponsoring employer is required (by interaction of the legal instrument under which the fund is established and the law) to pay contributions to the fund to enable the fund to pay the benefits promised by the plan.

**6.31 The analysis suggests that a 'net' presentation is justified conceptually in the employer's individual financial statements if the fund assumes the obligation to pay retirement benefits.**

6.32 This view is reflected in FRS 17, which argues that assets held by the fund **reduce** the employer's liability:

"A pension scheme can give rise to assets and liabilities of the employer but these are not the gross amounts of the pension scheme assets and liabilities – the employer does not control the assets nor is it directly liable for the pension payments. Instead, the employer has a pension asset or liability to the extent that it is entitled to benefit from any

surplus or has a legal or constructive obligation to make good any deficit." [FRS 17, Appendix IV paragraph 24]

*Further issues relating to the obligation to pay retirement benefits*

6.33 As presented, the above analysis assumes that the present obligation that gives rise to a liability of the fund is the same present obligation (i.e. it reflects the same cash payments that will arise in the future in respect of benefits that have been earned by employees in respect of their past service) as discussed in Section 5.

6.34 This need not necessarily always be the case. The treatment of future salary increases and discretionary increases in benefits might give rise to differences.

6.35 For example, if it is concluded that liabilities should reflect the effect of future salary increases, it can be argued that the additional liability that reflects the effect of future salary increases is a liability of the employing entity rather than of the fund until a pensionable salary increase is awarded. Until then the fund does not have a present obligation to the employee in relation to future salary increases; the employing entity does.

6.36 Similarly, if it is concluded that liabilities should reflect expected future discretionary increases to benefits already earned and the employing entity has discretion to award them, it can be argued that they are liabilities of the employing entity rather than the fund until increases are awarded.

On the other hand, if it is concluded that liabilities should not reflect future discretionary increases, but discretion to award future increases were ceded to the trustees of a fund, it can be argued that the fund does not have a liability to its members but the employing entity does have a liability to the fund (akin to a stand-ready obligation to pay uncertain future amounts to the fund).

### **Consolidated financial statements**

6.37 In June 2003 the IASB decided to undertake a project on consolidation based on a definition of control. The project includes considering whether effective control rather than legal control is a sufficient basis for consolidation. This paper utilises the preliminary findings and tentative decisions reached by the IASB in its consolidation project.

6.38 The IASB project update notes that:

*... control of an entity is the ability to direct the strategic financing and operating policies of an entity so as to access benefits flowing from the entity and increase maintain or protect the amount of those benefits.*

Therefore to control an entity a potential controller must satisfy three tests:

- *it must have the ability to direct the strategic financing*

*and operating policies of the entity (the 'Power Criterion');*

- *it must have the ability to access the benefits flowing from the entity (the 'Benefits Criterion');* and
- *it must be able to use its Power so as to increase, maintain or protect the amount of those Benefits.*

6.39 The IASB have formed a tentative view that irrespective of the form of control, if the above criteria are satisfied consolidation should be required. In other words, effective (de facto) control is a sufficient basis for consolidation.

#### *Power Criterion*

6.40 The IASB has tentatively agreed that a controller must have a non-shared (or unilateral) ability to direct strategic financing and operating policies to satisfy the Power Criterion. All sources of Power available to an entity whether held directly or indirectly should be considered in assessing Power. The Power Criterion is also satisfied whenever an entity has the ability to direct the strategic financing and operating policies, even if it elects not to exercise that power or has delegated (but not transferred) its power to another party, or even if it has a history of not utilising, or has no intention of utilising its ability.

#### *Benefits Criterion*

6.41 The IASB has tentatively concluded that the Benefits Criterion is satisfied whenever an

entity has an ability or capacity to obtain benefits, even if such benefits are not actually received.

*Link between the Power and Benefits criteria*

6.42 In order to distinguish whether a party is in the position of controller, control should be regarded as existing only if there is a link between the Power Criterion and the Benefits Criterion. The third test identified in paragraph 6.38 provides the link – that is to maintain or protect the benefit it derives. In other words, the ability to access benefits and to increase, maintain or protect the amount of those benefits must result from the controller’s ability to use its power.

***Retirement benefit plans***

*Contrast with subsidiary companies*

6.43 It is useful to contrast trusts (and similar entities) with subsidiary companies.

6.44 In essence a shareholder has the power to control a subsidiary company because a director of the subsidiary entity can be compelled by the parent entity to act in a particular manner – even if the director does not consider the transaction is the best interests of the company alone or is outside the scope of his powers, as his actions can generally be ratified by the parent entity.

6.45 In contrast a trustee must act for the benefit of the beneficiaries of the scheme. There is no similar concept of “shareholder ratification” – in essence the sponsoring entity

does not have the power to direct trustees in the same way he does a company director.

*Control*

**6.46 It is proposed that the consolidation issue is approached from the perspective of applying a control test, in the context of the conclusions being reached in the IASB’s consolidations project.**

6.47 Where a trust (or similar entity) is established trustees have a responsibility to manage the trust’s assets for the benefit of the beneficiaries of the trust. The trustees powers are set out in the trust deed/and or rules and in addition are often regulated by law.

6.48 The existence of the following factors suggest that the sponsoring employer of a trust (or similar entity) does not control the trust:

- trustees must act for benefit of the beneficiaries (this requirement is necessary regardless of who has the power to appoint and remove trustees);
- regulations determine how trustees should act when performing their duties and therefore restrict the sponsoring employer’s ability to “influence” trustees; and
- the access to benefits of the plan is limited to any surplus arising in the fund (to which this is typically shared with

employees and restricted by regulation).

6.49 Some accounting standards have adopted a risks and rewards approach in determining whether assets and liabilities should be recognised (or entities should be consolidated). Our approach is that it would not be appropriate for a sponsoring employer to recognise assets, or assets and liabilities of entities, that it does not control. However, further attention will be given to similarities and differences between retirement benefit trusts (and similar entities) and special purpose entities that are addressed in other accounting literature.

## **Appendix**

### **Issues arising earmarked for further consideration**

- Meaning of discretion in the context of benefits that are described as discretionary.
- Accounting for future administration expenses.
- Impact of pensions regulations (UK) since FRS 17 and IAS 19 were developed.
- Plan amendments.
- Liabilities in pension fund financial statements.
- Nature and characteristics of assets used to settle liabilities.
- Similarities and differences between retirement benefit trusts (and similar entities) and special purpose entities that are addressed in other accounting literature.