European Securities and Markets Authority

The Chair
Date: 21 November 2018
ESMA32-63-566

Sue Lloyd
Chair of the IFRS Interpretations Committee
30 Cannon Street
London EC4M 6XH
United Kingdom

Agenda Item Request: Distinction between defined contribution and defined benefit pension plans

Dear ~~Ms Lloyd~~, DEAR SUE,

The European Securities and Markets Authority (ESMA) is an independent EU Authority that contributes to enhancing the protection of investors and promoting stable and well-functioning financial markets in the European Union (EU). ESMA achieves this aim by building a single rule book for EU financial markets and ensuring its consistent application across the EU. In the context of its convergence work in the area of financial reporting, I would like to raise the following issue with you.

As a result of the reviews of financial statements carried out by national competent authorities and ESMA's co-ordination activities, we have noted a lack of clarity regarding the requirements of IAS 19 – *Employee Benefits* in the area of the definition of defined contribution and defined benefit pension plans, which could lead to a diversity in application of IFRS in the EU. Accordingly, ESMA kindly suggests that the IFRS Interpretations Committee considers clarifying the relevant accounting requirements.

A detailed description of the case is set out in the appendix to this letter.

In case you have any questions or comments regarding this letter, I suggest you contact Evert van Walsum, Head of the Investors and Issuers Department (Evert.vanWalsum@esma.europa.eu).

Yours sincerely,

Steven Maijoor

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APPENDIX – DETAILED DESCRIPTION OF THE ISSUE

1. As part of their monitoring and supervisory activities, ESMA and national enforcers have identified divergent application of accounting requirements with regards to post-employment benefits in scope of IAS 19. This particular issue relates to the distinction between defined contribution (DC) and defined benefit (DB) pension plans.

Description of the issue

2. An Issuer's pension plan is executed by a Company Pension Fund (Pension Fund). The funding agreement between the Issuer and the Pension Fund stipulates that the Issuer's obligation is to pay fixed contributions on a yearly basis. The issuer has no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.
3. The funding agreement also entails a discount arrangement, which entitles the Issuer to a potential discount on its annual contributions. This discount is calculated based on strict (retrospective) conditions including elements that are affected by economic, actuarial and investment risks related to the Pension Fund.
4. Paragraph 27 of IAS 19 states that post-employment benefit plans are classified as either DC plans or DB plans, depending on the economic substance of the plan as derived from its principal terms and conditions. Under IAS 19, every post-employment benefit plan is a DB plan unless it meets the characteristics of a DC plan. Paragraph 8 of IAS 19 defines DC plans as post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.
5. This submission focusses on whether the right to potential discounts affects the classification of an entity's pension plan as either a DB plan or a DC plan. In particular, the submission questions whether the definition of a DC plan (paragraph 8 of IAS 19) should be read as two cumulative criteria or whether the second part of the sentence should be read only as an clarification as to what qualifies as a fixed contribution.

View 1: The definition of a DC plan in paragraph 8 of IAS 19 comprises two cumulative criteria

6. Proponents of view 1 are of the opinion that the definition of a DC plan provides two cumulative criteria that both need to be met. Criterion 1 is that an entity pays fixed contributions. Criterion 2 is that an entity will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods. In the described issue, criterion 1 of the DC definition is not met, since the contributions to the Pension Fund over the lifetime of the plan are variable due to the potential discounts the Issuer

may receive under the discount arrangement. Hence the pension plan should be accounted for as a DB plan.

7. The other paragraphs of IAS 19 explain that the distinction between fixed and variable contributions made by an entity should be linked to the allocation of actuarial and/or investment risks. If an entity's yearly base contribution can vary upwards and/or downwards because of actuarial and/or investment circumstances, the relevant plan should be classified as a DB plan. If IAS 19 would not be explained in this way DB plans would unambiguously be restricted to plans under which an entity pays contributions that can be increased if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

8. The distinctive principle between DB and DC plans is whether there is variability in future contributions (as a result of retrospective elements) in whichever way structured. Given the definition of, and rationale behind the DC/DB distinction, the main question under IAS 19 is whether an entity's contributions are in any way dependent on the actuarial, investment and economic circumstances of the pension plan. If such dependency exists, the contributions are not fixed and hence the plan cannot be classified as a DC plan under IAS 19.

9. Proponents of view 1 find support for their view in paragraph 50 of IAS 19, which describes the accounting of DC plans and clearly states that "there is no possibility of any actuarial gain or loss".

View 2: The definition of a DC plan in paragraph 8 of IAS 19 comprises a single criterion

10. Proponents of view 2 are of the opinion that the second part of the definition of a DC plan is not a separate criterion, but should only be read as a clarification as to what qualifies as a fixed contribution.

11. The entity's right to future discounts results in an upside potential rather than a downside risk. Therefore, the right to future discounts, being only a refund of previous contribution, is not relevant for the classification of a post-employment benefit plan and does not prevent classification as a DC plan. As a result, the pension plan should be accounted for as a DC plan.

12. Paragraph 28 to 30 of IAS 19 provide further guidance as to the requirements of paragraph 27 of IAS 19. These regulations show that the classification of a DC plan focusses on the downside risk that the cost to the entity may increase. This follows from the following provisions of IAS 19:

    - paragraph 8 of IAS 19 defines DC plan with reference to "no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods."

    - paragraph 28 of IAS 19 states that "Under DC plans the entity's legal or constructive obligation is limited to the amount that it agrees to contribute to the fund."

- paragraph 29 of IAS 19 states that: "Examples of cases where an entity's obligation is not limited to the amount that it agrees to contribute to the fund are when the entity has a legal or constructive obligation through: (a) a plan benefit formula that is not linked solely to the amount of contributions and requires the entity to provide further contributions if assets are insufficient to meet the benefits in the plan benefit formula; [...]"
- paragraph 30 of IAS 19 states that "Under defined benefit plans: [...] (b) actuarial risk (that benefits will cost more than expected) [...] fall, in substance, on the entity [...]".

13. Proponents of view 2 find further support for the consideration that the classification of a DC plan focusses on the downside risk that the cost to the entity may increase in the following phrases from the basis for conclusions (BC) accompanying IAS 19:
    - Paragraph BC 29 of IAS 19 states that: "The definitions introduced in 1998 focused on the downside risk that the cost to the entity may increase. The definition of defined contribution plans does not exclude the upside potential that the cost to the entity may be less than expected."
    - Paragraph BC 30 of IAS 19 states that: "The amendments made in 2011 clarify that the existence of a benefit formula does not, by itself, create a defined benefit plan, but rather that there needs to be a link between the benefit formula and contributions that creates a legal or constructive obligation to contribute further amounts to meet the benefits specified by the benefit formula."
    - "This amendment to paragraph 29 addressed a concern that can arise when a plan has a benefit formula determining the benefits to be paid if there are sufficient plan assets, but not requiring the employer to pay additional contributions if there are insufficient plan assets to pay those benefits. In effect, the benefit payments are based on the lower of the benefit formula and the plan assets available. The amendments clarify that such a plan is a defined contribution plan."
14. IAS 19 and the accompanying BC state that the classification of a postemployment benefit plan as either a DC or a DB plan depends on the question whether the entity's legal or constructive obligation is limited to the amount that the entity agreed to contribute to the fund. The definition of DC plans does not exclude the upside potential that the cost to the entity may be less than expected. A contribution is fixed if the entity's legal or constructive obligation is limited to the amount that it agrees to contribute to the fund. The BC support this understanding. As a result the second part of the sentence should be read as a clarification as to what qualifies as a fixed contribution, hence future (potential) discounts are not relevant in qualifying whether a contribution is fixed or not.
15. Paragraph 50 of IAS 19 explains how to account for a DC plan, not whether it is a DC or DB plan. Classification of a plan is dealt with in paragraph 8 and further clarified in paragraphs 27 to 30 of IAS 19. Therefore, in the view of proponents of view 2, paragraph 50 of IAS 19 is not relevant in the classification as DB or DC.

Request

16. ESMA seeks clarification on whether the definition of a DC plan should be read as two cumulative criteria or whether the second part of the sentence should be read as an interpretation as to what qualifies as a fixed contribution, and that the classification of a post-employment benefit plan as either a DC or a DB plan focusses on the downside risk that the contribution of the entity may increase.
17. Furthermore, ESMA seeks clarification as to whether or not paragraph 50 of IAS 19 is relevant to the classification of a post-employment benefit plan as either a DC or a DB plan.
18. ESMA is of the view that the lack of clarity of IAS 19 can lead to divergent practices in various European jurisdictions and in other jurisdictions with significant DB pension plans. Accordingly, ESMA kindly suggests that the IFRS Interpretations Committee considers clarifying the accounting requirements in this respect.