

## Considerations about the Definition of Post-employment Benefit Obligation

Name:(Mr.) Yuzo Fujimoto

Title: Senior Researcher

Working for: The Sumitomo Trust & Banking Co., Ltd.

All views in this paper are attributed to the author individually. Any opinion is not connected to the employer of the author.

### Abstract

A project which reviews post-employment benefit accounting is making progress on IASB in recent years. This project includes two phases. After the first phase of this project, they will start the second phase which deals a comprehensive review of post-employment benefit accounting. In the comprehensive review phase, the most important and interesting subject might be the definition of post-employment benefit obligation. This subject is represented by some questions like, “Is post-employment benefit obligation defined as PBO, ABO or VBO?” and “Is straight-line based attribution necessary or not for back-end loaded benefit plan?” and has been being discussed since old days.

Judging from a lot of views about it, the answers to the questions seem to vary in every country. In short any answers of the questions cannot be a universal truth. And further consideration gives me an idea that the answers could change in every entity or for every employee group even in a same company.

So it is much more logical that we study the definition of post-employment benefit obligation, with the premise that the right of employee and the duty of employer differ for every employee group.

So what we have to do must be to establish a principle which decides the range to recognize with a background of the real relationship between employee and employer. And the principle I propose in my preliminary view is as follows;

<Principle>

Present post-employment benefit obligation exists when:

(a) the entity has no realistic alternative to settling the obligation and

(b) the obligation exists independently of the entity's future actions

with the premise that alternatives to settling the obligation and entity's future actions are restricted by not only law and contract but also social discipline and custom.

## 1. Introduction

A project which reviews post-employment benefit accounting is making progress on the International Accounting Standards Board (IASB) in recent years. This project includes two phases. After the first phase of this project, they will start the second phase which deals a comprehensive review of post-employment benefit accounting. Among many comment letters to the discussion paper for the first phase of this project, many respondents announced the necessity and importance of the comprehensive review of post-employment benefit accounting. It might indicate that the total review of post-employment benefit accounting is not only scheduled by IASB but also regarded as a necessary and important project by many persons concerned with post-employment benefit accounting.

The discussions about comprehensive review of post-employment benefit accounting are expected to make progress by IASB's decision to start to review it on IASB in several years. Among such discussions, there is a discussion paper about the comprehensive review written by Accounting Standard Board (ASB). It is published as a part of an activity, whose objective is to stimulate the debates about some accounting issue before IASB starts to discuss on the issue, acted by the European Financial Reporting Advisory Group (EFRAG) and several European accounting standard setters. (The name of the activity is "pro-active accounting activities in Europe (PAAinE)".) This discussion paper must have some lot of influence to IASB, judging from an episode that Sir David Tweedie, the chairman of IASB, said that the discussion paper was very helpful for the comprehensive review on IASB. And the original objective of the discussion paper might have already been achieved, because about 100 comment letters to it were submitted by many person concerned.

In the comprehensive review phase, the most important and interesting subject might be the definition of post-employment benefit obligation. This subject is represented by some questions like, "Is post-employment benefit obligation defined as PBO, ABO or VBO?" and "Is straight-line based attribution necessary or not for back-end loaded benefit plan?" and has been being discussed for many years.

In this paper, at first I present preliminary views of ASB's discussion paper about a definition of post-employment benefit obligation. Secondly I present the International Actuarial Association (IAA)'s view among comment letters to ASB's discussion paper. After those, I present an original view about a definition of post-employment benefit obligation.

## 2. General Discussion about Liability

In ASB's discussion paper they looked back the IASB's Framework, IAS37 'Provisions, Contingent Liabilities and Contingent Assets' and an exposure draft of IAS37, before they present the preliminary views, in order to go over the general discussions about liability. These contents are very helpful to consider the definition of post-employment benefit obligation, so I summarize them below.

The present definition of a liability in 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."

The important points of this definition are:

- (1) An obligation is something an entity cannot avoid.
- (2) A present obligation must have arisen from a past transaction or event.

And the Framework says that item should be recognized as a liability if:

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

IAS37 applies the definition of a liability to provisions generally. IAS37 requires that, for a present obligation to exist, it is necessary that

- (a) the entity has no realistic alternative to settling the obligation and
- (b) the obligation exists independently of the entity's future actions.

And IAS37 requires that an obligation must be either a legal obligation or a constructive obligation.

And the exposure draft of IAS37 requires that contingent liability is not recognized before the condition of the liability is satisfied. However the exposure draft of IAS37 proposes that many possible obligations that have previously been thought of as contingent liabilities contain unconditional obligations. The unconditional obligation is referred to as 'stand ready obligation' and is a liability.

These general discussions about liability are not preliminary views of ASB's discussion paper but views of IASB's standard. So these are usable to consider the definition of post-employment benefit obligation.

## 3. Preliminary Views of ASB's Discussion Paper

I summarize preliminary views of ASB's discussion paper about the definition of post-employment benefit obligation below.

In the discussion paper at first they argue when a liability begins to arise. They

compare three views:

(View1) A liability begins to arise when the promise of a benefit is made.

(View2) A liability begins to arise when services are provided.

(View3) A liability begins to arise when benefits vest.

They abandon (View1) because post-employment benefit obligation does not arise only with promises, since it arises after rendering services. And they abandon (View3) because, after rendering services before vesting, only the amount of benefit is uncertain with employer's commitment to pay benefit for services. In short, they abandon (View3) because an unvested benefit is 'stand-ready' obligation. So they support (View2).

Regarding the issue that salary increase should be reflected, they say the conclusion depends on a unit of account. In the case a unit of account is an individual employee, future salary increase should not be reflected, because the employer has a future discretion not to increase the individual employee's salary. And in the case a unit of account is the entire workforce of an enterprise, future salary increase should be reflected, because the entity does not have a right not to increase the salary of the entire workforce. Among these two views they recommend the first view implicitly.

With respect to an attribution of benefit, they criticize the present procedure. And they propose a preliminary view that recognition should be based on a principle "Only present obligations should be reflected as liabilities".

#### 4. Views of IAA's Comment Letter

Many responses were submitted to these ASB's preliminary views. Among them IAA's comment seems to be excellent, because it indicates the answer depends on the respondent's circumstances. IAA's views are summarized below.

They say there are two distinct approaches and, depending what is meant by the term 'liability', different forms of accounting should apply.

(Approach A)

If one takes the view that the accounts should record the value of the liability that the employer has incurred as of the balance sheet date, then the liability to be recorded would be akin to the FASB concept of a VBO.

No allowance would be made for future salary growth, indeed the question as to whether there may be a constructive obligation to pay benefits based on future salaries, or not, does not arise.

Similarly, the notion of uniformly accruing (a form of smoothing) back-end loaded benefit formulae would not arise either.

(Approach B)

Alternatively, one can take the view that the plan is an ongoing venture : the cost of the plan (the commitment to employees) should be spread over the period of time, in which the employee provides the services which earn that commitment. In that case the accounts should record the liability that the employer is required to provide to the employee, on the assumption that the employee continues to accrue benefits under the plan for future service.

Looking at future salary growth in final pay plans, one then needs to take a view whether an allowance should be made because

- a. there is a constructive obligation to increase salaries over time across the workforce as a whole
- b. there is a probability of future salary growth which impacts the liability to be measured and therefore should be taken into account

Similarly, the notion of uniformly accruing (a form of smoothing) back-end loaded benefit formulae would arise too.

#### 5. Importance of Differences of Law System, Social Discipline and Contract Practice

By analyzing several comment letters to ASB's discussion paper, the differences among views seem to depend on the differences of law system and social discipline, etc. of the each respondent's nation. For example an accounting-standard setter insists on PBO-based definition because long-term employment is social custom in his country.

Judging from this inclination, the answer to the question, "Is post-employment benefit obligation defined as PBO, ABO or VBO?" seems to vary in every country. In short any answer of the question cannot be a universal truth. And further consideration gives me an idea that the answer could change in every entity or for every employee group even in a same company.

The system of law of post-employment benefit differs in every country. And the social standard of employment also differs in every country. Further the employment custom differs in every enterprise. Since the relationship between employee and employer is diversified so much today, legal and constructive relationship between employee and employer differs for every employee group even in a same entity. So the right of employee and the duty of employer also differ for every employee group.

So it is much more logical that we study the definition of post-employment benefit obligation, with the premise that the right of employee and the duty of employer differ for every employee group. And it is much more appropriate for the fundamental objectives of accounting to define post-employment benefit obligation with being reflected by the actual relationship between employee and employer.

So in order to study the definition of post-employment benefit obligation, it does not make sense to choose PBO, ABO or VBO. And what we have to do must be to establish a principle which decides the range to recognize with a background of the real relationship between employee and employer. When the principle is established, we would be able to prepare appropriate financial statements for the fundamental objectives of accounting, which are comparable even in different countries.

#### 6. Principle which Defines Post-employment Benefit Obligation

I have to look back the general discussion argued in Chapter 2 in order to establish the principle which decides the range to recognize. In Chapter 2 with regard to provisions, for a present obligation to exist, it is necessary that

- (Criterion a) the entity has no realistic alternative to settling the obligation and
- (Criterion b) the obligation exists independently of the entity's future actions.

These two criteria can become the principle we seek, because these two are the fundamental requirements for provisions to be a present obligation. I propose a preliminary view that we recognize post-employment benefit obligation when the two criteria are satisfied.

However, since an obligation must be either a legal obligation or a constructive obligation, in relation to (Criterion a), 'alternatives to settling the obligation' are restricted by not only law and contract but also social discipline and custom. And because of the same reason, with relating to (Criterion b), 'entity's future actions' are restricted by not only law and contract but also social standard and convention. Expressing it in other words, alternatives to settling the obligation and entity's future actions are limited by not only explicit contracts but also implicit contracts.

#### 7. Relationship that an Employer has a Full Discretion of Dismissal and Future Salary

Firstly, suppose there is an employee group whose relationship with an employer is that the employer has a full discretion of dismissal and future salary not increasing. And suppose the post-employment benefit plan applied to them is a final salary plan which has a vesting period.

Because the entity has a full discretion not to increase future salary of the employee group, future salary increase is not necessarily included in the range of obligation which exists independently of the entity's future actions.

Because the entity has a full discretion to lay-off any employee of the employee group, the entity can dismiss any employee of the group before the vesting period is fulfilled. So the entity is not required to recognize the unvested obligation.

As similar to vesting, since the enterprise can lay-off any employee of the group on the balance sheet date, the entity does not have a necessity to attribute the benefit for the service period in a straight-line basis, even when the benefit is back-end loaded.

#### 8. Relationship that an Employer has No Discretion of Dismissal and Future Salary

Next, suppose there is an employee group whose relationship with an employer is that the entity has no discretion of dismissal and future salary not increasing. And suppose the post-employment benefit plan applied to them is a final salary plan which has a vesting period.

Because the entity has no discretion not to increase future salary of the employee group, future salary growth is necessarily reflected in the range of obligation which exists independently of the entity's future actions.

Because the entity has no discretion to lay-off any employee of the employee group, the entity cannot dismiss any employee of the group without the employee's voluntary severance in the vesting period. So since the entity has no choice to pay unvested benefit in future, if the employee intends to accept it, the entity is required to recognize the unvested obligation.

As similar to vesting, because the company has no choice to pay higher benefit in future, if the employee intends to accept it, the entity does have a necessity to attribute the benefit for the service period in a straight-line basis when the benefit is back-end loaded.

#### 9. In the Case of Proper Employees in Japanese Traditional Companies

In this chapter I examine the case of a proper employee in a Japanese traditional company.

Regarding to proper employees of Japanese traditional companies, it is difficult to lay-off them by social standard and social convention. In relation to salary growth there is a range that a company has to increase their salary especially in young days by social discipline and social custom.

Because the entity has no discretion not to increase future salary in the range described above, the necessary part of future salary increase should be considered to estimate post-employment benefit obligation.

Because the entity has little discretion to lay-off them, in the case post-employment benefit plan is a final salary plan which has a vesting period, unvested obligation should be recognized as same as Chapter 8.

Since a standard plan of a Japanese traditional company has a short period (generally

shorter than 3 years) without benefit, the Japanese company should recognize the obligation even in the benefit-less period.

After the benefit-less period, entity has to pay more valuable benefit if entity lay-off an employee than if an employee goes away from the company voluntarily by long-established social rule. Since lay-off causes higher amount of benefit than continuous employment, even if a Japanese company can dismiss any proper employee, the range to recognize should be the obligation which is calculated with the premise that the employee will render services to the entity continuously.

When the benefit is back-end loaded, the entity has a necessity to attribute the benefit for the service period in a uniformly accruing basis because of the same reason as Chapter 8.

But there is one special circumstance relative to the benefit-cut in Japan. In Japan an entity is able to decrease a post-employment benefit even the benefit corresponds to past service period by social convention and law system. Legally agreements of the employees are necessary in order to decrease a benefit. But by social convention employees and union usually agree the proposal of decreasing a benefit, as far as the range of decreasing is not too much. So the circumstance has to be reflected to the post-employment benefit obligation in Japan. Concretely post-employment benefit obligation has to be calculated for some portion of a presently contracted benefit, which is assumed to be inevitable in Japan.

#### 10. In the Case of Contingent Employees in Japanese Companies

A Japanese company does not usually have a post-employment benefit plan for contingent employees. In this Chapter I suppose there is a post-employment benefit plan for contingent employee in some Japanese company. And suppose the post-employment benefit plan applied to them is a final salary plan which has a vesting period.

In Japan usually an entity has a full discretion not to increase future salary of contingent employees. And also an entity usually has a full discretion to lay-off them.

As every condition is same as Chapter 7, the range to recognize is also same as Chapter 7.

#### 11. Problems of Principle Approach

I believe this principle approach is very appropriate for the fundamental objective of accounting in present days, in which relationship between employee and employer becomes widely diversified.



But some problems might arise. The most serious problem could be the possibility of abuse and manipulation, which become higher because the calculation procedures also become widely diversified.

Against it there must be two typical measures to take. One approach is audit and another approach is guideline.

Regarding the implicit contract between employee and employer, there are known to be several characteristics as a successful fruit of labor-economics, for example, the wage becomes higher for an employee who serves for long time than for an employee who serves for short time, even if their age are same, in the entity where the implicit contract exists. The characteristics like this could compose some guideline of this principle approach.

## 12. Conclusion

Calculating post-employment benefit obligation using a single procedure is ignoring the actual and real circumstances relative to the relationship between employee and employer.

Against it using a principle approach enables us to estimate appropriate obligation of post-employment benefit, which reflects the relationship between employee and employer and the difference of right and duty based on the differences of law scheme, social discipline and social custom, etc.

The principle established in this paper is persuasive enough, I believe, because it comes from the definition of present obligation corresponding to provision.

<Principle>

Present post-employment benefit obligation exists when:

(a) the entity has no realistic alternative to settling the obligation and

(b) the obligation exists independently of the entity's future actions

with the premise that alternatives to settling the obligation and entity's future actions are restricted by not only law and contract but also social discipline and custom.

(end of paper)

## Reference

1. EFRAG(PAAinE), ASB, Discussion Paper "The Financial Reporting of Pensions", JAN2008
2. IASB, Discussion Paper "Preliminary Views on Amendments to IAS 19 Employee Benefits", MAR2008