

Accounting Treatment of Pension Liability Post-Separation

The following is the opinion given by the Expert Advisory Committee of the Institute in response to a query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1. A company S (hereinafter referred to as the 'company') is a public limited company listed on National Stock Exchange (NSE) and Bombay Stock Exchange (BSE). In the year 2009, as a part of a business transfer agreement with one of its customers N, S took over 35 employees in Germany. As a part of the business transfer agreement, S agreed to takeover customer's employees under same terms and conditions under which employees were employed immediately prior to the agreement. It was also agreed that obligations of the customer N arising from employment relationships with transferred employees shall pass to S as on the agreement date. Towards this obligation, customer N reimbursed S for an amount as agreed on the agreement date. S will be responsible for all employee related obligations on and after the agreement date. Accordingly, the pension liabilities of the employees of N were taken over by S.
2. The querist has stated that under the German law, pension is a defined benefit plan. For the purpose of pension payments and administration, N had established a fully reinsured support fund which converted defined benefit plan into contribution type defined benefit plan. With transfer of pension liabilities to S, S got admitted to the fully reinsured support fund and took over the accumulated balances of the reinsured support fund of N. The basic principles of the reinsured support fund are detailed by the querist in Annexure I.
3. In the financial year (F.Y.) 2011-12, due to changes in business scenario, the transferred employees were terminated after complying the regulatory requirements in Germany. The pension liabilities continued to be with S as they would be paid out only on death of an employee or he/she reaching retirement age, whichever is earlier. S continues to make contribution which also includes a defined annual insurance premium to the reinsured support fund and keeps the reinsurance in force - the benefits of the insurance have been supplied by the querist in Annexure I. As per the querist, this is supposed to take care of the changes in the interest rates and make the scheme similar to defined contribution scheme by taking away the effect of changes in interest rates.
4. The querist has further stated that since the employees are no longer on rolls, the pension amounts and periodic contributions are not subject to any change on account of changes in base salary (as the base salary will be the same as on the date of separation). Further, the pension liability to the employee when it becomes due will be met by the support fund. The company continues to be liable for fulfillment of pension promise, in contingent events, such as, the insurance company goes bankrupt. In the event of underfunding, the employer must pay the part of the benefit due, which cannot be paid by the support fund (because of underfunding), out of its own means. Realistically, since the support fund is fully reinsured, and till such time that a contingent event happens, and as long as the reinsurance is in force, it is unlikely that there will be underfunding. In addition to the pension promise, the company is also liable for pension adjustments to the guaranteed vested amount due to inflation. Traditionally, the inflation rate in Germany has been around 2%. However, the company expects that the increase in the guaranteed return from the contributions made to the fund, will cover the inflation costs and therefore, there is a good chance that the inflation adjustments will be met by surplus in the fund.

B. Query

5. Given this background, the querist has sought the opinion of the Expert Advisory Committee as to whether the scheme can be treated as defined contribution scheme and accordingly, whether it is appropriate for the company to consider the periodic contribution only as its expense for a given period in the financials. Reason for this being that there is a periodical

payment to the support fund. This support fund will take care of the interest rate fluctuation and guarantee the payment to ex-employees on retirement or death whichever is earlier. This, as per the querist, will also eliminate the fluctuation in profit and loss account and make more sense to investors.

C. Points considered by the Committee

6. The Committee notes that the basic issue raised in the query relates to whether the pension scheme to the terminated employees in the extant case can be treated as defined contribution scheme and accordingly, whether it is appropriate for the company to consider the periodic contribution only as its expense for a given period in the financial statements. Accordingly, the Committee has considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, accounting in the financial statements (prepared, if any) of support fund and customer N, accounting for transfer of employees by N, whether the scheme in the extant case can be considered as multi-employer plan, detailed accounting aspects of the scheme, accounting as per the German accounting principles, etc.
7. The Committee notes from the Facts of the Case that the company took over employees of its customer N as a part of business transfer agreement under the same terms and conditions under which employees were employed immediately before the agreement. Further, the obligations of N including pension liabilities arising from employment relationship were transferred to company S. Later on in F.Y. 2011-12, the transferred employees were terminated. However, the pension liability continued to be with the company. In this connection, a question may arise with regard to the nature of pension benefits. Accordingly, the Committee notes the following requirements of Accounting Standard (AS) 15, 'Employee Benefits', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'):

"7.1 Employee benefits are all forms of consideration given by an enterprise in exchange for service rendered by employees."

"7.3 Post-employment benefits are employee benefits (other than termination benefits) which are payable after the completion of employment."

"7.9 Termination benefits are employee benefits payable as a result of either:

- (a) an enterprise's decision to terminate an employee's employment before the normal retirement date; or***
- (b) an employee's decision to accept voluntary redundancy in exchange for those benefits (voluntary retirement)."***

"133. This Standard deals with termination benefits separately from other employee benefits because the event which gives rise to an obligation is the termination rather than employee service."

"136. Some employee benefits are payable regardless of the reason for the employee's departure. The payment of such benefits is certain (subject to any vesting or minimum service requirements) but the timing of their payment is uncertain. Although such benefits may be described as termination indemnities, or termination gratuities, they are post employment benefits, rather than termination benefits and an enterprise accounts for them as post-employment benefits. Some enterprises provide a lower level of benefit for voluntary termination at the request of the employee (in substance, a post-employment benefit) than for involuntary termination at the request of the enterprise. The additional benefit payable on involuntary termination is a termination benefit."

The Committee notes from the Facts of the Case that the benefits to the employees are paid not due to their termination rather due to the service rendered by the employees before their termination. Therefore, the Committee is of the view that these cannot be considered as termination benefits and should be considered as post-employment benefits.

8. With regard to the type of post-employment plan, the Committee further notes the following requirements from AS 15:

"7.5 Defined contribution plans are post-employment benefit plans under which an enterprise pays fixed contributions into a separate entity (a fund) and will have no 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."

7.6 Defined benefit plans are post-employment benefit plans other than defined contribution plans.”

“24. Post-employment benefits include:

- (a) retirement benefits, e.g., gratuity and pension; and
- (b) other benefits, e.g., post-employment life insurance and post-employment medical care.

Arrangements whereby an enterprise provides post-employment benefits are post-employment benefit plans. An enterprise applies this Standard to all such arrangements whether or not they involve the establishment of a separate entity to receive contributions and to pay benefits.

25. Post-employment benefit plans are classified as either defined contribution plans or defined benefit plans, depending on the economic substance of the plan as derived from its principal terms and conditions. Under defined contribution plans:

- (a) the enterprise’s obligation is limited to the amount that it agrees to contribute to the fund. Thus, the amount of the post-employment benefits received by the employee is determined by the amount of contributions paid by an enterprise (and also by the employee) to a post-employment benefit plan or to an insurance company, together with investment returns arising from the contributions; and
- (b) in consequence, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall on the employee.

26. Examples of cases where an enterprise’s obligation is not limited to the amount that it agrees to contribute to the fund are when the enterprise has an obligation through:

- (a) a plan benefit formula that is not linked solely to the amount of contributions; or
- (b) a guarantee, either indirectly through a plan or directly, of a specified return on contributions; or

- (c) informal practices that give rise to an obligation, for example, an obligation may arise where an enterprise has a history of increasing benefits for former employees to keep pace with inflation even where there is no legal obligation to do so.

27. Under defined benefit plans:

- (a) the enterprise’s obligation is to provide the agreed benefits to current and former employees; and
- (b) actuarial risk (that benefits will cost more than expected) and investment risk fall, in substance, on the enterprise. If actuarial or investment experience are worse than expected, the enterprise’s obligation may be increased.”

“40. An enterprise may pay insurance premiums to fund a post-employment benefit plan. The enterprise should treat such a plan as a defined contribution plan unless the enterprise will have (either directly, or indirectly through the plan) an obligation to either:

- (a) pay the employee benefits directly when they fall due; or
- (b) pay further amounts if the insurer does not pay all future employee benefits relating to employee service in the current and prior periods.

If the enterprise retains such an obligation, the enterprise should treat the plan as a defined benefit plan.”

“42. Where an enterprise funds a post-employment benefit obligation by contributing to an insurance policy under which the enterprise (either directly, indirectly through the plan, through the mechanism for setting future premiums or through a related party relationship with the insurer) retains an obligation, the payment of the premiums does not amount to a defined contribution arrangement. It follows that the enterprise:

- (a) accounts for a qualifying insurance policy as a plan asset (see paragraph 7); and
- (b) recognises other insurance policies as reimbursement rights (if the

policies satisfy the criteria in paragraph 103).

43. Where an insurance policy is in the name of a specified plan participant or a group of plan participants and the enterprise does not have any obligation to cover any loss on the policy, the enterprise has no obligation to pay benefits to the employees and the insurer has sole responsibility for paying the benefits. The payment of fixed premiums under such contracts is, in substance, the settlement of the employee benefit obligation, rather than an investment to meet the obligation. Consequently, the enterprise no longer has an asset or a liability. Therefore, an enterprise treats such payments as contributions to a defined contribution plan.”

The Committee notes from the Facts of the Case that although the pension liability to the employee when it becomes due will be met by the support fund, which is fully reinsured, the company continues to be liable for fulfillment of pension promise, in contingent events such as, if the insurance company goes bankrupt and in the event of underfunding. Thus, the employer, viz., the company will have to pay the part of the benefit due, which cannot be paid by the support fund (because of underfunding) out of its own means. Further, in addition to the pension promise, the company is also liable for pension adjustments to the guaranteed vested amount

due to inflation. Thus, although the company expects that the increase in the guaranteed return from the contributions made to the fund, will cover the inflation costs and the inflation adjustments will be met by surplus in the fund, in case surplus in the fund is not able to meet inflation adjustments, the same will be met by the company. Accordingly, the Committee is of the view that since in case of underfunding with the support fund and in case of contingency of insolvency of insurer, deficit is to be met by the employer (company S), the plan in the extant case is a defined benefit plan and not a defined contribution plan. Therefore, the company cannot treat only the periodic contributions for a period as its expenses in its financial statements.

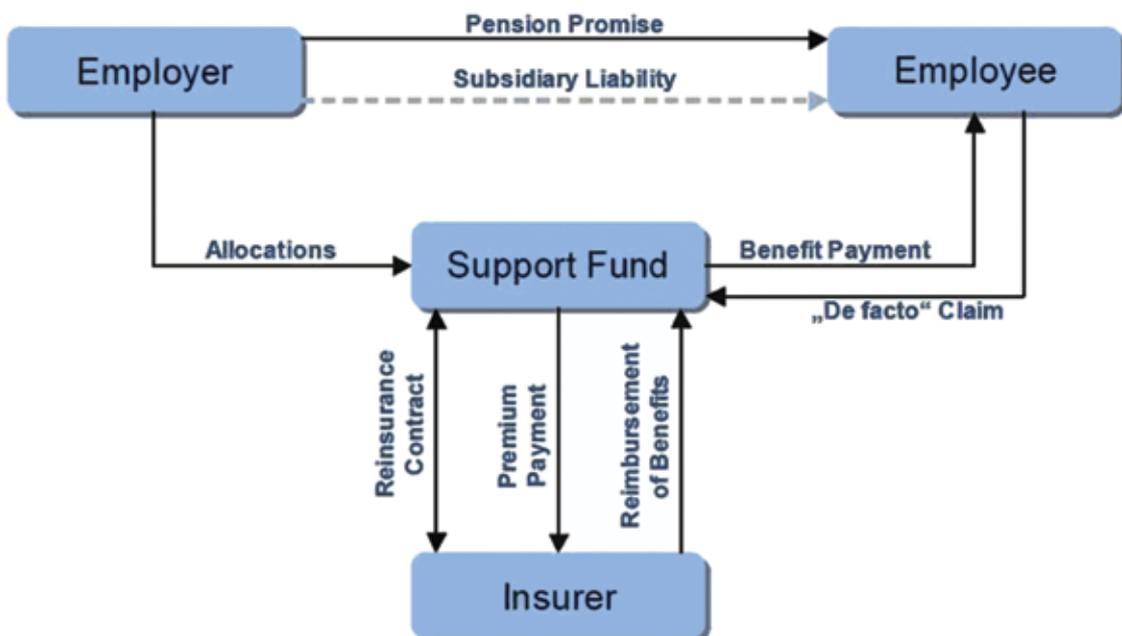
D. Opinion

- On the basis of the above, the Committee is of the opinion that the pension scheme in the extant case cannot be treated as defined contribution scheme and accordingly, it is not appropriate to consider the periodic contribution only as its expense for a given period in the financial statements of the company, as discussed in paragraph 8 above.

Annexure I

Reinsured support fund

The graph below illustrates the basic principle of financing occupational pensions or lumpsum benefits by a reinsured support fund:



Opinion

The basic principle of a contribution-type defined benefit plan financed by a fully reinsured support fund can be briefly described as follows:

- The employer gives a pension promise in line with the support fund's benefit plan ('Leistungsplan der Unterstützungskasse') to the employee.
- The scope of employer contributions is commonly defined in the plan document (e.g., a fixed percentage of the employee's annual gross base salary in the particular calendar year).
- These defined contributions are paid by the employer to the support fund ('allocations').
- The support fund takes out a life insurance (reinsurance) contract on the employee's life and as the policy-holder, is entitled to the insured benefits.
- The reinsurance premiums payable by the support fund to the life insurer are identical with the amount of employer contributions.
- According to the applicable plan provisions, the employee is entitled to benefits equal to the benefits insured under the reinsurance policy.
- Thus, defined employer contributions are actuarially converted into guaranteed minimum entitlements to benefits on the basis of a life insurance tariff. Up to the guaranteed interest rate, the insurer and lower-ranking-the employer (due to the subsidiary liability e.g. in the event of insolvency of the insurer) bear the investment risk.
- In excess of the guaranteed interest rate, the employee bears the investment risk. However, the plan concept also offers good prospects for the employee, as dividends granted by the insurer are entirely used to increase his/her entitlement to benefits.
- After the occurrence of an event giving right to a benefit (e.g., retirement or death), the support fund receives the insured benefit plus dividends from the life insurer and, simultaneously, pays out the benefit due to the beneficiary.
- As a rule, mandatory adjustments of pensions (e.g., pre-retirement disability of the employee) in payment can be financed by the dividends granted by the insurer.
- Due to legal constraints, a support fund is not allowed to grant a legal claim to benefits. This fact, however, does not result in a potential risk or disadvantage for the employee.
- According to the German Company Pension Law, the sponsoring company (i.e., the employer) remains liable for the fulfillment of the pension

promise (so called subsidiary liability). Thus, in the (unlikely) event of underfunding (e.g., insolvency), the employer must pay the part of the benefit due which cannot be paid by the support fund (because of underfunding) out of own means.

- According to the German Company Pension Act, the employer is obliged to contribute towards the statutory insolvency protection ('Pensions-Sicherungs-Verein') of the Government of Germany, even if the support fund takes out congruent reinsurance. The insolvency protection insurance covers the risk of insolvency of the Government of Germany.
- As per German tax and accounting standards, corporates/listed companies in Germany are not required to account for such pension assets and obligations as assets and liabilities in their balance sheet. Instead, a mere disclosure in notes to accounts of any deficits (i.e., pension obligations minus support fund's assets) is sufficient, given that the support fund has claim to benefits under the re-insurance contract to cover the defined benefit obligations to the employees.

1	The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
2	The Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on June 3, 2015. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.
3	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty four volumes. A CD of Compendium of Opinions containing thirty four volume has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.
4	Recent opinions of the Committee are available on the website of the Institute under the head 'Resources'.
5	Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head 'Resources'. For further information, write to eac@icai.in .