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Disclosures relating to Belgian “defined contribution” plans with return guaranteed by law

Executive summary

- In 2014 the FSMA started a project on the financial reporting of Belgian defined contribution pension plans with return guaranteed by the Law of 28 April 2003 regarding occupational pensions (WAP/LPC). With this publication the FSMA seeks to improve financial reporting on those plans in the IFRS financial statements of Belgian listed entities.
- Because the employer has to guarantee the statutory minimum return on these plans, not all actuarial and investment risks relating to these plans are transferred to the insurance company or pension fund managing the plans. Therefore these plans do not meet the definition of defined contribution plans under IFRS and should by default be classified as defined benefit plans. However, accounting for these plans in the IFRS financial statements is not straightforward.
- Several publications of the IASB and IFRS IC confirm that plans with contribution-based promises were not envisaged by IAS 19 and that the accounting for these plans in accordance with IAS 19 is problematic.
- In practice, we observed two methods for estimating the liability in relation to entities' Belgian pension plans: a method based on the IAS 19 methodology (15 % of our sample) and an intrinsic value method (85 % of our sample). The first method calculates the liability as the difference between the present value of the defined benefit obligation and the fair value of plan assets, while the second method measures the liability at intrinsic value.
- Although financial reporting on Belgian defined contribution plans has improved, there is still a lot of room for improvement. The FSMA expects entities to provide at least the following information on their material Belgian defined contribution plans with statutory minimum return in their notes to the financial statements:
    - a clear description of the specific characteristics of Belgian defined contribution plans, indicating the risks borne by the entity in relation to these plans;
    - a clear disclosure and justification of accounting policies adopted in order to measure the liability to be recognized;
    - a description of all relevant assumptions and estimates used to calculate this liability;
    - quantitative disclosures on the measurement of the liability; and
    - information about the amount, timing and uncertainty of future cash flows.

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1. INTRODUCTION

In 2013 the FSMA published a study on the information provided by listed companies about post-employment benefits in their 2012 financial statements[1]. One of the conclusions of this study was that the notes to a significant number of financial statements contained no clear and precise information, and sometimes no information at all, about the risks, classification and measurement of defined contribution plans with minimum return guaranteed by law[2].

The topic has received more attention recently because several insurance companies reduced the technical interest rate[3] on group insurance contracts to a level below the minimum return guaranteed by law for Belgian defined contribution pension plans. Informal contacts with different stakeholders have indicated a need for a broader discussion on the impact of the reduction in technical interest rates on the financial reporting of these plans in the IFRS financial statements. Moreover, discussions and documents of both the IASB and IFRIC IC suggest that the financial reporting of these plans is not straightforward.

Taking into account the shortcomings in financial reporting observed in the FSMA's 2013 study, recent market trends and the fact that the IASB has not yet been able to provide more guidance on the treatment of these types of plans, the FSMA launched a project on the financial reporting on Belgian defined contribution pension plans.

The purpose of this project was threefold:

(1) to gain insight into the size of these plans at companies listed on the Belgian regulated market and into the financial reporting on these plans;
(2) to open a discussion forum where the views of different stakeholders regarding the financial reporting on these plans can be exchanged; and
(3) to enhance disclosures about the accounting treatment and the risks of these plans and to reduce diversity in practices (where possible).

However, it should be stressed that the FSMA is not a standard setter or an interpretation committee, and is bound by the application of the existing Standards and Interpretations.

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1 FSMA, Considerations regarding the information about post-employment benefits disclosed by listed companies in their 2012 annual financial statements, Studies and Documents No. 43, December 2013.
2 But not offering any other rate guarantee.
3 Most companies pay insurance premiums to fund these plans. The insurance companies promise a certain return on the contributions, and this return is called the technical interest rate.

In the first phase of this project, the FSMA conducted an in-depth study of the topic and sent out a questionnaire to the auditors of a random sample of 44 Belgian listed companies in order to gather information on the materiality and financial reporting of these plans in the 2013 IFRS financial statements and the rationale behind the accounting policies adopted. The responses received made it possible to identify the different views on the application of IAS 19 amongst the listed companies and audit firms.

In the second phase, a meeting was held with representatives of the auditors, pension funds, actuaries and insurance companies in order to exchange views. Following this meeting, several working groups were established amongst the different stakeholders.

With the present publication the FSMA seeks to create further awareness of the fact that defined contribution plans with a statutory guaranteed minimum return do not meet the definition of a defined contribution plan under IFRS and of the consequences thereof. The main objective of this paper is to improve the disclosures regarding the characteristics of the plans, the related risks, the accounting policies applied and the amounts recognized in the financial statements.

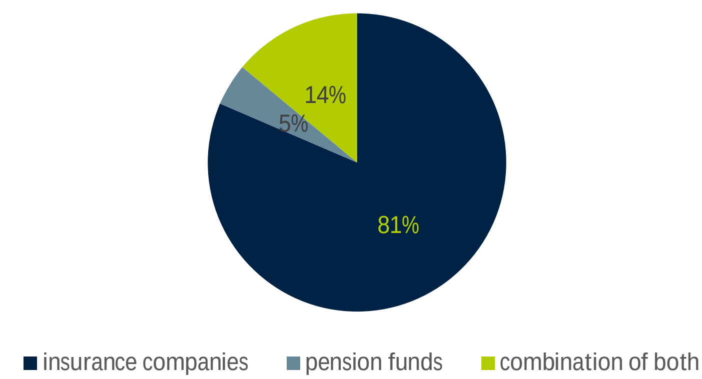
2. PLANS IN THE SCOPE OF THE PROJECT

The scope of the project was limited to Belgian defined contribution plans. Belgian defined contribution plans are subject to the Law of 28 April 2003 on occupational pensions (hereafter "the WAP/LPC")[4]. According to article 24 of this Law, the employer has to guarantee an average minimum return of 3,75% on employee contributions and of 3,25% on employer contributions.[5].

The statutory guaranteed minimum returns can be modified by Royal Decree. In the event of a modification, the new rates will apply from the date of the change onwards to both past and future contributions.

Of the 44 listed companies in our study, only one company had no Belgian defined contribution plan for its employees. All the other companies had at least some employees with defined contribution plans subject to the Belgian guaranteed minimum return.

Figure 1 provides an overview of the funding of the plans under study.



As can be seen in the chart, for a large majority of the companies under study (81 %), these types of plans are funded by contributions to an insurance company.

In the past, the technical interest rate applied by these insurance companies was typically at least equal to the statutory guaranteed minimum return. However, this is changing. Lately, insurance companies have been reducing their technical interest rates to a level below the statutory guaranteed minimum return[6]. Some insurance companies, however, are still trying to achieve the statutory guaranteed minimum rates of return by means of profit-sharing[7].

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4 Wet betreffende de aanvullende pensioenen en het belastingstelsel van die pensioenen en van sommige aanvullende voordelen inzake sociale zekerheid (W.A.P.)/ Loi relative aux pensions complémentaires et au régime fiscal de celles-ci et de certains avantages complémentaires en matière de sécurité sociale (L.P.C.), Belgisch Staatsblad/ Moniteur belge, 15 May 2003, Erratum 26 May 2003.

5 See Article 24 of the Law of 28 April 2003 for the amount of the contributions subject to the statutory minimum return (for example, this does not include the amount linked to coverage of death or disability risk).

6 For example: *De Tijd*, "AG Insurance verlaagt rente voor groepsverzekeringen", 5 December 2014.

7 For example: *De Tijd*, "Ultralage rente zet groepsverzekeringen onder druk", 11 September 2014.

3. APPLICATION OF IAS 19 TO BELGIAN DEFINED CONTRIBUTION PLANS

The accounting treatment of the plans under study is not straightforward. Under IAS 19 there are in fact only two types of plans, and the classification of a given plan is determined on the basis of the economic substance of the plan as derived from its principal terms and conditions. The classification depends on which party (entity or employee) bears the actuarial and investment risk.

IAS 19.8 distinguishes the following post-employment benefits:

(1) defined contribution plans, where the entity pays fixed contributions into a fund (separate vehicle) and 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. This means that the employee bears all the risks and no liability has to be recognized by the entity; and

(2) defined benefit plans, which comprise all other post-employment benefit plans.

It is clear that the classification does not depend on the funding of the plan or the presence or absence of a deficit.

Article 24 of the WAP/LPC obliges the employer to ensure that plan members receive at the date of leaving the plan at least the amount of the contributions capitalized at the statutory guaranteed minimum rate. Therefore the Belgian defined contribution plans do not meet the definition of defined contribution plans and should by default be classified as defined benefit plans under IAS 19. Moreover, these pension plans do not meet the requirements to be considered as insured benefits (which are also treated as defined contribution plans) as defined by IAS 19.46, since the entity has to pay further amounts if the insurer does not meet its obligations.

Although the classification of the Belgian pension plans as defined benefit plans under the current version of IAS 19 seems quite clear, the accounting is less so. Several attempts by the IASB and by IFRIC to address the issue of employee benefit plans with a promised return on contributions were never finalized[8]. In September 2014[9], the IASB indicated its support for a review of the accounting for post-employment benefits that range from pure defined contribution to pure defined benefit plans. It acknowledges that there is a growing range of hybrid plan designs that incorporate features of both defined contribution and defined benefit plans, and that such plans were not envisaged when IAS 19 was developed and are therefore becoming problematic under IAS 19.

[8] Amongst others, IFRIC D9 – Employee benefit plans with a promised return on contributions or notional contributions, published in September 2004, was never finalized. In May 2012, IFRS IC noted that the 2011 amendments to IAS 19 did not address elements specific to contribution-based promises. In February 2014 IFRS IC indicated that developing accounting requirements for these plans would be better addressed by a broader consideration of accounting for employee benefits, potentially through the research agenda of the IASB, and in May 2014 it decided to remove the issue from its agenda.

[9] See IASB Update, September 2014.

In the absence of a specific accounting policy for these hybrid plans in IFRS, it can be argued that, as provided for in IAS 8.10, management must use its judgment in developing and applying an accounting policy that is relevant and reliable. To this end, entities have to take into account the requirements in IFRSs dealing with similar and related issues and the guidance in the Framework.

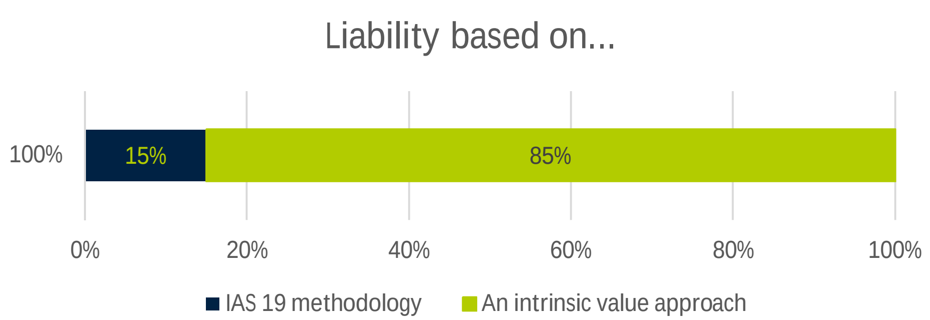
4. MEASUREMENT OF THE PENSION LIABILITY – OBSERVATIONS IN PRACTICE

An analysis of the responses received to our questionnaire revealed that in the past almost all the listed companies in our sample recognized the annual contributions paid for these contracts in profit and loss and did not recognize any liability for these types of plans. In order to justify this accounting treatment, companies indicated that no (material) liability for these plans existed at financial reporting date.

However, for plans funded by contributions to insurance companies this is likely to change because of the recent drop in technical interest rates applied by insurance companies.

There appear to be two methods used currently to determine whether or not a liability should be recognized at financial reporting date: an IAS 19-based methodology and an intrinsic value approach.

Figure 2 presents an analysis of the responses received to the questionnaires sent to the auditors of the listed companies in the sample. The companies without or with immaterial Belgian defined contribution plans are not included.



4.1. LIABILITY BASED ON IAS 19 METHODOLOGY (PUC)

15 % of the companies used the methods described in IAS 19 as a basis for determining whether or not a liability should be recognized.

Description of the method

Under IAS 19 a liability for defined benefit plans should be calculated as the difference between the present value of the defined benefit obligation and the fair value of plan assets.

The Projected Unit Credit (PUC) method is described in IAS 19 as the actuarial technique to be applied to measure the defined benefit obligation. It involves making a projection of future benefits using the best estimate assumption, attributing these benefits to current and prior periods under the plan's benefit formula and then discounting these benefits using a discount rate which reflects the yield of high quality corporate bonds in order to determine the present value of the defined benefit obligation (DBO).

The present value of the DBO is then compared to the fair value of the plan assets in order to determine the liability to be recognized in the statement of financial position. In the event of a surplus, application of the asset ceiling prevents the recognition of a surplus in certain circumstances.

Judgment is necessary to apply this method to Belgian pension plans.

First of all, different options for making a projection of contributions could be considered. Strict application of the PUC methodology would mean the projection of contributions based on the greater of the guaranteed minimum rates of return and a best estimate of the expected rate of return. The IFRIC draft interpretation (2004)[10] concerning the accounting for employee benefit plans with a promised return introduced an approach whereby these projections were basically based on the fixed guaranteed rate of return. However, this interpretation was never finalized.

The entity also has to decide whether it considers the plans to be backloaded (i.e. whether an employee's service in later years will lead to a materially higher level of benefit than in earlier years). In the case of a backloaded plan, an entity shall attribute the benefits to current and prior periods on a straight-line basis, instead of on the basis of the plan's benefit formula. Belgian defined contribution plans are typically flat-rate based (x %S) or step-rate based (x1 %S1+x2 %S2), which means that the contributions will be influenced by future salary increases[11]. BC117-120 indicates that the IASB did not decide whether expected future salary increases should be included in determining whether a benefit formula expressed in terms of current salary allocates a materially higher level of benefit in later years.

The plan assets have to be measured at their fair value. In the case of an insured plan, this entails measuring the fair value of the insurance contracts. IAS 19.115 indicates that where plan assets include qualifying insurance policies that exactly match the amount and timing of some or all of the benefits payable under the plan, the fair value of those insurance policies is deemed to be the present value of the related obligations. From discussions with the different stakeholders it appeared that there were divergent views on the application of IAS 19.115.

Examples of potential problems with applying the PUC method to the Belgian DC plans

- in several projects, IASB and IFRIC acknowledge that the accounting for these plans in accordance with IAS 19 is problematic[12];
- a strict application of IAS 19 (i.e. projection at expected rate of return and discounting at the market yields on high quality corporate bonds) would result in a counter-intuitive result: an increase of the expected rate of return on the contributions would, ceteris paribus, lead to an increase of the liability;
- the use of the statutory guaranteed minimum return as the projection rate is not a strict application of the method described in IAS 19 and assumes that this guaranteed minimum return will not change over time. Moreover, if bond yields were to rise again, this would increase the discount rate

10 IFRIC D9 – Employee benefit plans with a promised return on contributions or notional contributions.

11 S = Salary

12 IFRIC, Staff paper 9, Employee benefits plans with a guaranteed return on contribution or notional contributions, May 2014.

and the projection at guaranteed minimum return could lead to recognizing an expense in profit and loss that is smaller than the contributions paid.

4.2. INTRINSIC VALUE APPROACH

A large majority of the listed companies in our sample (85 %) use an intrinsic value approach to determine whether or not a liability should be recognized for the plans under study.

Description of the method

This method is used by those companies that consider the application of the PUC method problematic in the Belgian context. They consider that the PUC method is not desirable and that this alternative method can be used temporarily until the IASB issues a final statement.

The method consists in calculating the liability in the statement of financial position as the sum of any individual differences between the mathematical reserves (reserve calculated by capitalizing the past contributions at the technical interest rate applied by the insurance company, taking profit-sharing into account) and the minimum guarantee as determined by Article 24 of the WAP/LPC (calculated by applying the minimum return on the contributions paid).

The main difference between this method and the method required by IAS 19 is that contributions are not projected to calculate the defined benefit obligation.

Examples of potential problems with applying this method to the Belgian DC plans

- application of this method means that the issuer deems that the current guidelines in IFRS are not suited to defined contribution plans with minimum guaranteed return, and that another relevant and reliable method should be applied until the IASB comes up with an appropriate treatment;
- the liability recognised in the financial statements does not take into account the fact that the company must guarantee the statutory minimum return until the date of leaving the plan nor does it take into account future contributions, employee turnover, etc.

5. DISCLOSURES

The FSMA wishes to stress that since companies face a certain level of risk that would not exist if there was no statutory minimum guaranteed return, Belgian defined contribution plans do not meet the definition of defined contribution plans under IFRS. Therefore, the FSMA is of opinion that, for all material plans, it is essential that these additional risks are should be correctly reflected in the financial statements and the accompanying notes.

The FSMA considers that the materiality of these plans should be evaluated not only by the magnitude of the liability to be recognized, but also by the size of the plan itself (size of the obligation or vested reserves, number of participants, assessment of risk in the event of financial difficulties at the insurance company or the pension fund, etc.).

IAS 19.135 sets a number of objectives for the disclosures about defined benefit plans: the entity shall disclose information that

- explains the characteristics of its defined benefit plans and risks associated with them;
- identifies and explains the amounts in its financial statements arising from its defined benefit plans; and
- describes how its defined benefit plans may affect the amount, timing and uncertainty of the entity's future cash flows.

To meet this objective, IAS 19.138 explicitly states that companies must assess whether all or some disclosures should be disaggregated in order to distinguish plans or groups of plans with materially different risks. Thus, disclosures regarding plans may be disaggregated based on different geographical locations, characteristics, regulatory environments, reporting segments or funding arrangements.

The FSMA is of the opinion that since defined contribution plans with statutory minimum guaranteed return have specific characteristics and their risks are materially different from the risks of defined contribution plans without statutory guaranteed return, or typical defined benefit plans, the disclosures should be disaggregated.

5.1. CHARACTERISTICS AND RISKS ASSOCIATED WITH THE PLANS UNDER STUDY

To comply with the requirements in IAS 19.139, entities should disclose the characteristics of the plans and the risks associated with them. In particular the financial statements should include a clear description of the Belgian situation and the statutory guaranteed return. Issuers should also disclose how the plans are funded (through a pension fund or through an insurance company).

In practice, we see diversity in the disclosures relating to these plans. One of the findings of our previous study, on the information about post-employment benefits disclosed by listed companies in their 2012 accounts, was that there were very few companies that disclosed whether they had defined contribution plans with a statutory guaranteed minimum return, and if they did disclose this fact, these further disclosures were very general and contained little of no information on the risks or the measurement of these plans.

An analysis of the notes to the 2013 financial statements published by the random sample of 44 listed companies under study showed a positive trend in the attention paid to disclosures about these plans as compared to the findings of our previous study.

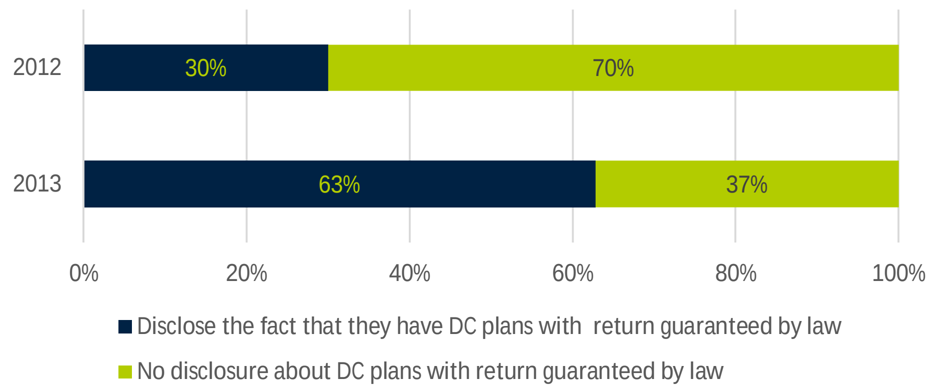


Figure 3 shows that 63 % of the companies in the sample disclosed, in their 2013 financial statements, that they have defined contribution plans with statutory guaranteed minimum return, whereas in our 2012 study only 30 % of the companies[13] did so.

However, an analysis of the disclosures showed that most disclosures remain very general and do not provide a clear description of the risks associated with the plans. 60 % of the companies that disclosed that they had Belgian defined contribution plans did not mention that it is the employer who has to guarantee the statutory return. Some companies even state, contrary to article 24 of the WAP / LPC, that, beyond their contributions, they have no further obligations in respect of these plans. Only 16 % of the companies with insured plans mention the recent declines in technical interest rates.

5.2. EXPLANATION OF THE AMOUNTS IN THE FINANCIAL STATEMENTS

5.2.1. Accounting policy choice

As the IASB indicates that the application of IAS 19 to hybrid plans is problematic and that views differ on how IAS 19 is to be applied to the Belgian defined contribution pension plans, readers of financial statements cannot rely on their knowledge of general IFRS requirements in order to understand the treatment of these plans in the financial statements of a specific entity. Therefore it is of key importance that entities clearly disclose and justify their accounting policy choices (IAS 1.117). Note that IAS 1.121 requires the disclosure of each significant accounting policy that is not specifically required by IFRSs but is selected and applied by the entity in accordance with IAS 8.

Where the accounting policy of the entity is based on IAS 19, it should disclose important estimates and judgments such as which projection rate to use, whether the plans are considered to be back loaded, whether IAS 19.115 is considered applicable and if so, how it is applied, etc.

[13] It should be noted that the samples selected in the two years were different. In the study on the 2012 accounts, 27 listed companies were selected that reported a present value of their defined benefit obligation greater than or equal to 5 % of consolidated equity. For this project a random sample was selected of 44 listed companies.

Where another method is used, the entity should justify the use of this method and indicate why it is considered to provide a solution to the problems presented by the PUC method required by IAS 19 and why this method is assumed to provide high-quality information. For the intrinsic value method, details should be provided on the valuation of the intrinsic liability.

5.2.2. Explanation of amounts in the financial statements

The FSMA is of the opinion that even where no liability should be recognized by application of the IAS 19 methodology or an intrinsic value approach for these plans, the entity should still provide quantitative disclosures for all material defined contribution plans with a statutory guaranteed minimum return.

When the entity applies the IAS 19 methodology to these plans, it should disclose the information required in IAS 19.140-144.

These disclosure requirements cannot be applied directly where the company deviates from the IAS 19 methodology. However, the FSMA is of the opinion that in those cases the entity should also make sure that the general objective in IAS 19.135(b) is met. This means that the entity should disclose quantitative information on how the liability was measured and how it changes from one year to another, for example by providing reconciliations and details on the funding of the plan.

Where an intrinsic value approach is used to estimate whether or not a liability should be recognized for insured plans, the FSMA is of the opinion that quantitative information is necessary at least on the sum of the minimum guaranteed reserves (Art. 24, WAP/LPC), the sum of the mathematical reserves and the sum of the differences between the mathematical reserves and the minimum guarantee in the individual accounts.

Based on our review, there is a clear need to improve disclosures in this respect.

5.3. AMOUNT, TIMING AND UNCERTAINTY OF FUTURE CASH FLOWS

As requested by IAS 19.145 an entity that applies the IAS 19 PUC methodology to these plans should disclose a sensitivity analysis for each significant actuarial assumption used to estimate the amount of the liability.

If the entity uses an intrinsic value approach, the entity should mention that the calculation of the liability takes into account the guaranteed minimum return only until the financial reporting date. The fact that the guaranteed minimum return must also be achieved in the future can have an impact on future cash flows.

Irrespective of the accounting policy choice, entities should disclose information on the funding arrangements and funding policy, the expected contributions and the maturity profile of the pension obligation, as required by IAS 19.147.

6. CONCLUSIONS

Since the entities bear some of the actuarial and investment risks of the Belgian defined contribution pension plans with statutory guaranteed minimum return, it is clear that these plans do not meet the definition of defined contribution plans under IFRS and have to be classified as defined benefit plans.

However, the strict application of the IAS 19 defined benefit methodology to these plans is not straightforward. In several documents, the IASB and IFRIC acknowledge that hybrid plans that incorporate features of both defined contribution and defined benefit plans were not envisaged when IAS 19 was developed and that accounting for these plans in accordance with IAS 19 can be problematic. In the absence of a specific accounting policy for these hybrid plans in IFRS, it can be argued that management has to use its judgment in developing and applying an accounting policy that is relevant and reliable, as stated in IAS 8.10.

In practice we observed two methods being used for estimating the pension liability: a method based on the IAS 19 methodology and an intrinsic value approach. The first method uses the IAS 19 methodology for defined benefit plans as a basis to determine the pension liability and requires certain assumptions and accounting policy choices regarding the rate of return, back loading, measurement of plan assets, etc. In the second method the liability is measured at intrinsic value. This method is used by entities that consider that IAS 19 cannot be applied to these plans and that therefore another method should be used temporarily until the IASB provides guidelines on the accounting treatment of plans with a promised return on contributions. The FSMA wants to stress that the accounting method applied should be properly disclosed and justified (IAS 1.117).

The FSMA wishes to stress that since entities face some of the actuarial and investment risk for defined contribution plans with a statutory guaranteed minimum return, it is essential that these risks be correctly reflected in the financial statements and its notes.

Based on our review of the financial statements of 44 listed companies, we noted an improvement of the disclosures relating to Belgian defined contribution pension plans when compared with the results of our previous study, but there is still a lot of room for improvement.

The FSMA is of the opinion that an entity should provide at least the following information on Belgian defined contribution plans in its notes to the financial statements:

- a clear description of the specific characteristics of Belgian defined contribution plans, indicating the risks of the entity in relation to these plans;
- a clear disclosure and justification of accounting policies adopted to measure the liability to be recognized;
- a description of all relevant assumptions and estimates used to calculate this liability;
- quantitative disclosures on the measurement of the liability; and
- information about the amount, timing and uncertainty of future cash flows.

This information should be provided for all material plans (even if the liability to be recognized is not material) and disaggregated from the information provided about ‘pure’ defined benefit plans.