<u>COMMENTS ON IPSAS CONSULTATION PAPER ON SOCIAL BENEFITS</u>

Prepared by the Statistics Directorate of the OECD, 28 January 2016.

<u>Comment 1</u>

(a) Is the scope of this (i.e., excluding other transfers in kind, collective goods and services, and transactions covered in other IPSASs) appropriate?

We broadly agree with the scope as described in the Consultation Paper, although we have the impression that the title of the Consultation Paper is not fully in line with this scope. The title refers to 'social benefits', whereas the scope seems to be limited to social benefits by public sector entities excluding employment-related social insurance benefits. In that regard, we think it would be clearer to define the title of the project 'social benefits under social assistance and social security' or 'social benefits other than employment-related benefits' to clearly distinguish it from benefits described under IPSAS 25. In saying that, it would be interesting to see how the rules under this CP would relate to the guidelines for employment-related benefits. If they would also be applicable to them, it may not be needed to have two separate sets of accounting standards. In that regard, we do not think that transactions covered in other IPSASs should be excluded beforehand, but that these should be reviewed in conjunction with these new guidelines.

Looking at the scope itself, we agree that it is appropriate to exclude 'collective goods and services' as these do not relate to individual households and consequently should not be regarded as social benefits. However, with regard to the exclusion of 'other transfers in kind', it is not fully clear to us what this would entail. Paragraphs 2.23 and 2.24 of the CP elaborate on that, but seem to contain some inconsistencies, at least in reference to the 2008 SNA. Paragraph 2.23 explains that "certain significant government expenditures for goods and services provided to individuals, and households fall outside of the SNA definition of social benefits" as they "cover other risks that would not impact on household's budget". It is stated that within the SNA these transfers are treated as "social transfers in kind". However, we don't think this is correct. "Social transfers in kind" are regarded as social benefits in the 2008 SNA (see 2008 SNA paragraph 17.79) and the two examples presented in paragraph 2.24 on health and education services are indeed treated as such in the SNA and should, in our view, be included in the scope of the project. Therefore, we think other examples should be included in the CP with reference to benefits "provided to individuals and households other than to protect against a social risk". By definition these types of benefits are not 'social transfers in kind' according to the 2008 SNA, but 'other current transfers' (SNA code D7). In this, one has to realise that the related amounts (with regard to benefits from government to households) are usually small.

(b) Do the definitions in Preliminary View 1 provide an appropriate basis for an IPSAS on social benefits?

Most of the definitions seem appropriate in our view. However, we think that two of them are too narrow as they already seem to be limited to the public sector. This is the case for the definition of 'social benefits in cash' and 'social benefits in kind' that state that these are paid "on behalf of a public sector entity". However, according to the 2008 SNA, social benefits can also be paid by employers, financial corporations (both only in cash) and non-profit institutions serving households (both in cash and in kind) (see paragraph 17.86). Furthermore, in relation to the scope of the project, we think it would also be good to include a definition of employment-related social insurance, to clearly distinguish it from social security (see also comment under 1a).

More fundamentally, we think that additional definitions may be needed to provide further guidance to help determining when to recognize an obligation for social benefits. The definition of a liability that is used in the CP refers to a 'past event' that creates a 'valid expectation'. This is defined in IPSAS 19 as "an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation". However, this may still give rise to interpretations, as various past practices may lead to varying expectations. It will in our view depend on the event in combination with the characteristics of the scheme whether it indeed leads to an accrual of an entitlement. Some expectations will be based on the combination of events that have already taken place (meeting necessary and sufficient eligibility criteria) and past practices or statements of government (giving rise to 'unconditional' expectations), whereas past practices or statements of government may also give rise to future expectations but with the knowledge that it still requires actions (or specific events) by the participants, such as tax or premium payments (giving rise to 'conditional' expectations)[1]. In the case of the 'unconditional' expectations, in our view an entitlement has indeed accrued for future benefits, whereas in the case of 'conditional' expectations the accrual will take place in the future, depending on other triggering events. We think it would be good to clearly distinguish between these two types of expectations[2] and link them to the concept of accrual accounting[3]. In our view, looking at the accrual principle, it will come down to the question whether a scheme creates a valid expectation of future entitlements on the basis of events in the current period. If the premiums (or taxes) or triggering events accrue an entitlement only for the same period, it will only give rise to a liability for the same period (a current liability that would be paid off within the next reporting period). However, if the premiums (or taxes) or triggering events accrue expected benefits for a point in time in the future, a liability will be created. As we think that

[1] For instance, from past experience one may have a valid expectation that the government will provide unemployment benefits in case a person becomes unemployed, but as it is usually the case persons will need to keep paying taxes or premiums year in year out to stay eligible. With the payment of taxes or premiums a person only accrues an 'insurance' entitlement for the period at stake, just like it would be the case under a non-life insurance scheme. On the other hand, one can argue that social security pension entitlements accrue over time on the basis of meeting eligibility criteria overtime. On the basis of meeting these criteria, one can establish a valid expectation of receiving benefits in the future on the basis of these past events, without (for the accrued-to-date entitlements) having to make any more contributions, just as it would be the case as this would be organised by a life insurance corporation. The triggering event of meeting the eligibility criteria in the second case in our view leads to a valid unconditional expectation of future payments, whereas meeting the criteria in the first case only leads to a valid expectation of payments in the current time period. The determination of the exact eligibility criteria and corresponding coverage of social benefit schemes is therefore crucial in our respect. Definitions need to be included to clearly define these terms.

[2] To include obligations for future unemployment benefits without including the corresponding future contributions, would lead to an incorrect view of government finances in our view. Moreover, it would lead to incomparable results with countries that organise these types of social risk insurance via insurance companies for which only accrued entitlements are recorded.

[3] 2008 SNA paragraph 2.55 states that "transactions between institutional units have to be recorded when claims and obligations arise, are transformed or are cancelled." Paragraph 3.166 elaborates that accrual accounting means that a flow is recorded at the time that economic value is created, transformed, exchanged, transferred or extinguished. Paragraph 3.167 elaborates that many transactions are monetary transactions in which some asset is delivered against immediate, or nearly immediate, payment in cash.

the concept of accrual accounting is closely related to coverage and eligibility criteria of schemes, we think it may also be good to provide some clearer guidance on these concepts.

<u>**Comment 2**</u>

(a) Based on your review of Chapters 4 to 6, which approach or approaches do you support?

- **(i) The obligating event approach;**
- **(ii) The social contract approach;**
- **(iii) The insurance approach**

Please provide reasons for your views, including the conceptual merits and weaknesses of each option; the extent to which each option addresses the objectives of financial reporting; and how the different options might provide useful information about the different types of social benefit.

Option (i) in our view has the following merits:

In this approach, all obligations that have accrued-to-date are included, as of the point that the 'valid expectation' arises by meeting the necessary and sufficient eligibility criteria. This will lead to comparable results across social benefit schemes (and between these schemes and similar insurance schemes) that will provide users with a clear picture of the financial situation of an entity at a given point in time.

The weakness is that it is not yet clearly defined at what stage a valid expectation will arise. As explained under comment 1b), in our view, this will depend on the eligibility criteria and the coverage, and therefore will differ across social benefit schemes. More guidance is needed to clearly define at what point the 'past event' takes place that triggers the obligation and what exact obligation it triggers. What is actually being accrued in a specific period? If this is clearly defined, we think that this option would probably work perfectly.

Another weakness of this approach may be that it does not provide insights in financial consequences of expected future accruals, as it only looks at what has been accrued-to-date. However, as will be explained under option (iii), we have some doubts whether it will be possible to provide comparable, comprehensive calculations on expected future accruals for all types of social benefit categories and in that way, we think it may be better to stick to accrued-to-date entitlements.

Option (ii) in our view has the following merits:

We think this approach clearly explains the situation for most of the social benefit categories and also clearly explains why these should not give rise to any entitlements with regard to what has been accrued-to-date. Most categories will indeed be based on the principle that current taxes and other sources of finances are used to finance the current benefits and that they will not give rise to any entitlements (outside the coverage period) as the coverage is limited to the current period. Taxes, premiums and other means of finance are used to cover the current benefits and in case the government would decide to quit one of these social benefit programs (together with the cancellation of the collection of corresponding premiums or taxes), the government would usually not be confronted with any outstanding expected claims on the basis of past contributions. For these schemes, obligations and entitlements accrue in the same pattern and are offset before the end of the coverage period. Therefore, they do not lead to any entitlements remaining at the end of the coverage period. It will depend on the characteristics (with regard to coverage period and eligibility criteria) of the specific schemes whether these schemes indeed qualify as 'social contract approach' types of schemes. In case there is a valid expectation that contributing in period t entitles you to a benefit in t+1 regardless of whether the scheme will still exist, this means that an entitlement has accrued and the relevant unit should record an obligation. In that way, in our view, it is a specific case within option (i). By clearly defining 'coverage period' and 'eligibility criteria', these types of schemes will be clearly recognized and treated accordingly.

Option (iii) in our view has the following merits:

As this approach includes both past accruals (accrued-to-date entitlements (i.e. benefits for the current and past contributors)) and future accruals (future entitlements (i.e. benefits that will be accrued by current and future contributors), and future receipts by current and future contributors), this approach gives a comprehensive overview of the financial situation of a social benefit scheme. However, as is explained in the CP this will only be the case for contributory schemes. For the other schemes it will turn out to be too difficult to make estimates of future receipts. In that way, this approach will lead to incomparable results between schemes. That is considered as a major downside. We think that this can only be solved a) by making a forecast of future receipts for the other schemes, or b) by excluding future entitlements and future receipts from the estimates. In the latter case, this approach would only describe the accrued-to-date entitlements and would be equal to option (i). Looking at the issue from a National Accounts perspective, which is based on the accrual principle, this would also be perfectly fine. According to the SNA, only this accrued-to-date part should be regarded as the actual obligation.

Furthermore, another problem with the insurance approach in our view is with its use of the net position from expected future cash flows; this implies that future taxes/contributions may need to be recognized before the taxable/contributable event has occurred, which would not be consistent with standard accounting practice nor with other established accounting standards.

Looking at the three options, we support option (i) as it applies (in our view after further tuning some of the definitions) accrual accounting principles to the 'valid expectations'. This will lead to comparable results across social benefit schemes and between these schemes and similar insurance schemes. In our view, it would also be best to go with only one approach and not have a combination of multiple ones, as the latter may easily give rise to discussions on when to apply which and to differences in interpretation. When looking at the approaches, we also have the impression that the obligating event approach generally covers the other two approaches , as long as the relevant 'past events' are defined properly in accordance with the characteristics (coverage and eligibility criteria) of the schemes. For 'social contract approach' schemes, the 'past event' would be the start of the new coverage period in which new taxes and other sources of finances will be received to pay for the expected benefits for that period. It can then be either the moment that the claim becomes enforceable or that the claim is approved to recognize the liability. When looking at the 'insurance approach', the obligating event approach would also work for the accrued-to-date part, as looking at the coverage and eligibility characteristics of a scheme it can be determined how and when entitlements accrue. On the other hand, it does not foresee in estimates for the expected future entitlements and obligations, but as we explained before we think it is questionable whether these would lead to comparable results anyhow. In our view, any estimates of expected future obligations and of future receipts with regard to contributory schemes, in case they are included, should only be presented as memorandum items.

(b) Are you aware of any additional approaches to accounting for social benefits that the IPSASB should consider in developing an IPSAS? If yes, please describe such approach(es) and explain the strengths and weaknesses of each.

No.

Comment 3

Having reviewed the three options in Chapters 4 to 6, are you aware of any social benefits transactions that have not been discussed in the CP, and which could not be addressed by one or more of the options set out in the CP? If so, please provide details of the social benefit transactions you have identified and explain why the options set out in the CP do not adequately cover these transactions.

No. However, it would be useful to clarify how other related government transactions would be classified within the framework of the definitions discussed in Chapter 2. For example, would government services such as mail postal service, public libraries and public utilities be classified as an "other social service" described in paragraph 2.4a or would it be a "community amenity" referenced in 2.5 in cases where they are partially subsidized using funds from taxation? Or would these be considered collective goods and services (even though, in these examples, the delivery of the good/service can be attributed to a single person or household)?

Comment 4

In your view, at what point should a future IPSAS specify that an obligating event arises under the obligating event approach? Is this when:

- **(a) Key participatory events have occurred;**
- **(b) Threshold eligibility criteria have been satisfied;**
- **(c) The eligibility criteria to receive the next benefit have been satisfied;**
- **(d) A claim has been approved;**

(e) **A claim is enforceable;**
(f) **At some other point.**

In coming to this conclusion, please explain what you consider to be the relative strengths and weaknesses of each view. If in your view, a future IPSAS should consider that an obligating event can arise at different points depending on the nature of the social benefit or the legal framework under which the benefit arises, please provide details. Please explain the reasons for your views.

We would prefer option A, with the additional comment that it should concern not only ‘key’, but ‘necessary and sufficient’ events to be eligible for a benefit in a certain period. This will depend on the eligibility criteria and the coverage period of the schemes. Looking at post-employment benefits, the obligations should in our view be recognized when the participatory event has occurred. As soon as a worker has been employed for the minimum period of time to be eligible for unemployment benefits in case he gets unemployed within a certain coverage period, an obligation has been created with regard to that coverage period that the government entity has little or no realistic alternative to avoid. As soon as an individual has lived in the country for the minimum period of residence to be eligible to receive various social benefits (and when those benefits are not dependent on future contributions by the person or society), an obligation has been created that the government entity has little or no realistic alternative to avoid. The measurement of such obligations may need to factor the coverage, probability and timing of when such benefits will be claimed (with the assistance of actuaries), but a material obligation exists as soon as the necessary and sufficient participatory criteria have been met by each individual.

Sub-options B, C, D and E are not feasible, as any later recognition could be interpreted as a material understatement of the obligations that an entity has accrued with respect to social benefits. These sub-options are also not consistent with IPSAS 23 for taxes or IPSAS 25 for post-employment benefits.

Comment 5

In your view, does an obligating event occur earlier for contributory schemes than non-contributory schemes under the obligating event approach? Please explain the reasons for your views.

No. Ceteris paribus, it should not make a difference whether a scheme is contributory or not. The recognition of the obligation should only depend upon the legal basis or the strength of the constructive obligation. The point in time for recognition may be dependent on which sub-option is selected, but not on being contributory or not.

Comment 6

In your view, should a social benefit provided through an exchange transaction be accounted for:

(a) **In accordance with a future IPSAS on social benefits; or**
(b) **In accordance with other IPSASs?**

Please provide any examples you may have of social benefits arising from exchange transactions. Please explain the reasons for your views.

As we assume that these transactions are probably similar to other exchange transactions that have already been covered by other IPSASs, we think these benefits should be accounted for in accordance with other IPSASs.

<u>**Comment 7**</u>

In your view, under the obligating event approach, when should scheme assets be included in the presentation of a social benefit scheme:

- **(a) In all cases**
- **(b) For contributory schemes;**
- **(c) Never; or**
- **(d) Another approach (please specify)?**

Please explain the reasons for your views.

In our view, if assets are earmarked within the scheme to pay out future benefits, these should always be included in the presentation (option a). This provides the most accurate information on the financial obligations associated with the scheme, regardless of whether it is contributory or not. For both types of schemes, option (a) would provide information on the funding that will be used to meet future obligations.

Further to this, we would like to add that only assets that have accrued-to-date should be recognized. As is explained in paragraph 1.33 of the Consultation Paper, RPG 1 has already addressed the need for information about the long-term fiscal sustainability of social benefits provided by an entity. As such, it is explained that the recording should be in line with regular reporting requirements for financial statements. In our view, this means that the IPSAS on social benefits should follow the normal practices of accrual accounting and therefore should be consistent with established accounting principles. For example, IPSAS 23 states that "an entity shall recognize an asset in respect of taxes when the taxable event occurs and the asset recognition criteria are met." This means that taxes expected to be collected in future years cannot be recognized before the taxable event occurs. The recognition of scheme assets, such as social security contributions, should follow a similar principle.

<u>**Comment 8**</u>

In your view, under the social contract approach, should a public sector entity:

- **(a) Recognize an obligation in respect of social benefits at the point at which:**
  (i) A claim becomes enforceable; or
  (ii) A claim is approved?
- **(b) Measure this liability at the cost of fulfilment?**

Please explain the reasons for your views.

We do not have a clear preference on when to recognize the obligation, except that we think it would be best to align the recognition of the obligation for the government entity to the recognition of the entitlements for the household. Under the social contract approach the government complies by providing goods, services and cash transfers and the society complies by contributing taxes or other sources of finance. In our view, it is important that for both obligations the same principle of recognition is applied.

The liability should in our view indeed be recorded at cost of fulfilment.

<u>Comment 9</u>

Do you agree with the IPSASB's conclusion about the applicability of the insurance approach?

Please explain the reasons for your views.

We do not agree with these conclusions. In our view the contributory aspect of a social benefit is not decisive in whether or not to regard the social benefit as being provided under a type of insurance. The liabilities can, in our view, regardless of being paid for by contributions or being subsidized, be measured as current estimates of future cash flows (as under option 1). Depending on the way of financing (participatory or not), the premiums (receivable) could also be recorded accordingly. In our view, it would therefore not be necessary to have a separate approach for this.

IPSASB should consider the possibility that the applicability of the insurance approach may need to be based on the underlying nature of the liability and how it accrues to date. If the obligation to pay a social benefit must be continually renewed by an obligating event (such as a beneficiary's payment of unemployment insurance contributions), then the liability accrues in a much different manner than an obligation that persists after contributions have ceased (such as the beneficiary's payment of pension contributions). This is akin to term life insurance versus whole life insurance. One liability is expected to expire without payment (for the majority of participants) and is dependent upon the continual receipt of contributions, while another liability persists and can continue to accumulate in value beyond the contributory period (in the case of pension indexing). IPSASB should consider whether the proposed applicability of the insurance approach fundamentally reflects the nature of how a liability has accrued for a government entity.

Furthermore, a practical issue with the proposed applicability is that it would treat social benefit schemes with dedicated funding differently from social benefit schemes that do not have dedicated funding. The result may be a government balance sheet with various liabilities that have not been measured consistently; some items may represent accrued-to-date obligations while others may represent expected deficits arising from future cash inflows and outflows. Further consideration should be given to how liabilities arising from social benefits can be treated in a consistent manner.

<u>Comment 10</u>

Under the insurance approach, do you agree that where a social security scheme is designed to be fully funded from contributions:

(a) Any expected surplus should be recognized over the coverage period of the scheme; and
(b) Any expected deficit should be recognized as an expense on initial recognition?

Please explain the reasons for your views.

Expected surpluses and expected deficits should be treated in the same manner to ensure consistency in the recognition and measurement of social benefits over time. This is particularly important for a scheme that is close to break-even and could shift between a surplus and a deficit position.

The recognition of an expense pertaining to a social security benefit is complicated by its various components, including the equivalents to its service cost, interest cost, actuarial gains/losses, and curtailments/settlements. We recommend that the IPSASB consider using IPSAS 25 as a starting point in formulating the appropriate recognition of the expected surplus/deficit of a social security benefit.

<u>Comment 11</u>

In your view, under the insurance approach, what is the appropriate accounting treatment for the expected deficit of a social security scheme that is not designed to be fully funded from contributions:

(a) Recognize the deficit as an expense on initial recognition;
(b) Recognize the deficit as an expense over the coverage period of the scheme;
(c) Offset the planned subsidy and the liability only where this is to be received as a transfer from another public sector entity;
(d) Offset the planned subsidy and the liability irrespective of whether this is to be received as a transfer from another public sector entity or as an earmarked portion of general taxation; or
(e) Another approach?

Please explain the reasons for your views.

We prefer option B as expected surpluses and deficits represent flows (not stocks) and therefore they should be recognized as flows over the coverage period.

Options C and D appear to be inconsistent with established accounting principles, because these options imply that a liability does not exist until the funding to pay for it is earmarked or reallocated from elsewhere. The funding for a social benefit has no relevance to the existence of the obligation to pay the beneficiaries.

<u>Comment 12</u>

In your view, under the insurance approach, should an entity use the cost of fulfilment measurement basis or the assumption price measurement basis for measuring liabilities?

Please explain the reasons for your views.

The cost of fulfilment is the more appropriate basis in our view as it represents an objective approach to measuring the liabilities. As stated in paragraph 6.43, the assumption price would not be appropriate for the public sector where there is no third party that might assume the liability. Furthermore, we are assuming that the cost of fulfilment approach would be conducted under the principle of neutrality (such as in International Standard of Actuarial Practice 2, paragraph 2.3) whereby all assumptions are made such that the resulting projection is not considered to be a material underestimate or overestimate, and as such, material levels of uncertainty would already be reflected in the measurement of the liability on a cost of fulfilment basis. The cost of fulfilment represents the best estimate of the cost that is expected to be incurred.

<u>Comment 13</u>

Do you agree that, in those cases where the link between contributions and benefits is not straightforward, the criteria for determining whether the insurance approach is appropriate are:

- **The substance of the scheme is that of a social insurance scheme; and**
- **There is a clear link between the benefits paid by a social security scheme and the revenue that finances the scheme.**

If you disagree, please specify the criteria that you consider should be used.

Please explain the reasons for your views.

We agree with the first criterion. However, the second criterion should be stricter to ensure that there is a dedicated and fixed source of revenue that is clearly attributable to the social security scheme. If the second criterion provides too much flexibility in the interpretation of the link between benefits and contributions, then the resulting measurements could lose relevance, as it would be easy for every social security scheme to have an expected net cash flow of zero based on the assumption that the government will simply reallocate revenues from other sources to pay for any deficits in that scheme.

<u>Comment 14</u>

Do you support the proposal that, under the insurance approach, the discount rate used to reflect the time value of money should be determined in the same way as for IPSAS 25?

Please explain the reasons for your views.

Yes, in our view IPSASB should maximize, to the extent possible, the consistency between the measurement of liabilities from employee benefits and liabilities from social benefits.

Comment 15

Under the insurance approach, do you support the proposals for subsequent measurement set out in paragraphs 6.73-6.76?

Please explain the reasons for your views.

We recommend that the IPSASB considers using IPSAS 25 as a guide in formulating the appropriate subsequent measurement. This will maximize consistency across established accounting standards.