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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

IFRIC meeting:	**September 2007, London**
Project:	**IAS 19 – *Employee Benefits*** **Treatment of employee contributions (Agenda Paper 6A)**

Issues

1. The IFRIC received a request to clarify the treatment of employee contributions in a cost-sharing pension plan (cf. appendix 2). In some plans, employee contribution rates vary depending on the overall funding of the plan, for example an arrangement in which the cost of providing the benefits is shared between the members and the employer in the ratio 40:60. If surpluses arise, they are often distributed in a similar manner and current guidelines on surplus distribution include a requirement that at least 40% of any surplus distribution must be allocated to the members.

2. The accounting issues raised in the submission are whether:
   - the service cost should reflect the cost-sharing nature of the arrangement;
   - any surplus that must be used to adjust members' benefits or required contributions should be treated as an addition to the liability;

- any additional contributions that are expected to be required from members to finance a deficit should be treated as a deduction from the liability.

3. However, the more basic issue is how employee contributions should be accounted for in general.

Staff analysis

Employee contributions

4. The issue is how contributions received from employees towards the cost of a defined benefit plan should be accounted for under IAS 19. The staff has identified two types of employee contributions:

   - contributions to the ongoing funding of the plan, usually payable in each period, and
   - contributions payable when benefits (e.g. medical costs) are paid.

a) Annual contributions

5. IAS 19 paragraph 7 gives the following definitions:

   - The present value of a defined benefit obligation is the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.
   - The current service cost is the increase in the present value of the defined benefit obligation resulting from employee service in the current period.

6. Paragraph 120A of IAS 19 also states that "an entity shall disclose the following information about defined benefit plans:

   …

   (c) a reconciliation of opening and closing balances of the present value of the defined benefit obligation showing separately, if applicable, the effects during the period attributable to each of the following:

   (i) current service cost,

   …

   (iii) contributions by plan participants,

7. Therefore, the staff believe that IAS 19 seems clear that contributions to a pension plan received during the reporting period from employees towards the cost of their pension plan should be deducted from the current service cost.

There is no effect on the defined benefit obligation because such contributions are paid during the service period.

b) Contributions payable when benefits are paid

8. Paragraph 91 of IAS 19 states that "some post-employment health care plans require employees to contribute to the medical costs covered by the plan. Estimates of future medical costs take account of any such contributions, based on the terms of the plan at the balance sheet date (or based on any constructive obligation that goes beyond those terms)." Therefore, it also seems clear that these contributions required by the terms of a health care plan will affect the defined benefit obligation.

b) Under US GAAP and Canadian GAAP

9. US GAAP and Canadian GAAP both give more detailed guidance on the treatment of employee contributions that is consistent with the general requirements of IAS 19 although US GAAP is silent on the treatment of employee contributions to the ongoing funding of a plan. Canadian GAAP, paragraphs 71 to 74 of Section 3461 makes a clear distinction between contributions from current employees towards their pension plan (assuming it would be unlikely that retirees would be contributing to their pension plan), and contributions from retirees and current employees towards their other retirement benefits:

Current service cost

.071 • *For a defined benefit plan, an entity should determine its current service cost for a period as the actuarial present value of benefits attributed to employees' services rendered during that period in accordance with paragraphs 3461.038 and 3461.042, reduced to reflect employee contributions.* [JAN. 2000]

.072 Contributions towards the cost of retirement benefits may be received from active employees or from retirees. For example, employees may contribute to a pension plan during their service life and retirees may contribute towards the cost of a drug plan.

.073 Contributions received during a period from active employees towards the cost of a pension plan reduce the current service cost in the period.

.074 When contributions are expected to be received from employees in future periods towards the cost of retirement benefits other than pensions, an entity's accrued benefit obligation is measured as the actuarial present value of the benefits expected to be provided, reduced by the actuarial present value of contributions expected to be received from employees in future periods. In determining the amount of those contributions, an entity considers any related plan provisions, such as its past practice of consistently increasing or reducing the contribution rate as described in paragraphs 3461.061-.062. An obligation to return contributions received from employees who do not attain eligibility for future benefits, together with any interest accrued on those contributions, is recognized as a component of an entity's accrued benefit obligation. These factors are reflected also in an entity's current service cost.

Employee contributions in a cost-sharing pension plan

10. The first issue is whether cost-sharing provisions in a defined benefit plan should be taken into account in determining both the current service cost and the defined benefit obligation.

11. Paragraph 83 (b) of IAS 19 states that "post-employment benefit obligations shall be measured on a basis that reflects the benefits set out <u>in the terms of the plan</u> (or resulting from any constructive obligation that goes beyond those terms) at the balance sheet date" (emphasis added). Therefore, if the cost-sharing arrangement is part of the terms of the plan, the entity should take those terms into account in determining both the current service cost and the defined benefit obligation.

12. The second issue is whether any surplus that must be used to adjust members' benefits or required contributions should be treated as an addition to the liability.

13. Paragraph 85 of IAS 19 states that "if the formal terms of a plan (or a constructive obligation that goes beyond those terms) require an entity to change benefits in future periods, the measurement of the obligation reflects those changes. This is the case when, for example:

    (a) the entity has a past history of increasing benefits, for example, to mitigate the effects of inflation, and there is no indication that this practice will change in the future; or

    (b) actuarial gains have already been recognised in the financial statements and the entity is obliged, by either the formal terms of a plan (or a constructive obligation that goes beyond those terms) or legislation, to use any surplus in the plan for the benefit of plan participants (see paragraph 98(c))."

14. Therefore, the staff believe that IAS 19 is clear that surplus-sharing provisions in defined benefit plans should be taken into account when measuring the obligation. That is, any existing surplus in a plan that must be used either to

improve benefits or to reduce employee contributions cannot reduce the employer's defined benefit obligation.

15. The third issue is whether any additional contributions that will be required from members to help finance a deficit should be treated as a deduction from the liability.

16. IAS 19 is silent on this third issue and deals only with surpluses. In the case of increased costs or a deficit, the terms of the plan may permit the employer to increase the contributions the employees will be required to pay to partially fund the deficiency.

17. As noted earlier, IAS 19 paragraph 91 indicates that 'Estimates of future [medical] costs take account of any such contributions, based on the terms of the plan at the balance sheet date'. Paragraph 3461.74 of Canadian GAAP adds detail to this requirement, also as noted above, that 'an entity's accrued benefit obligation is measured as the actuarial present value of the benefits expected to be provided, reduced by the actuarial present value of contributions expected to be received from employees in future periods. In determining the amount of those contributions, an entity considers any related plan provisions, such as its past practice of consistently <u>increasing or reducing</u> the contribution rate' (emphasis added).

18. Therefore, the staff believe that IAS 19 seems clear that if the terms of a defined benefit plan include cost-sharing provisions, the employer's ability to increase required employee contributions should be taken into account when measuring the obligation.

Staff recommendation

19. Because the staff believes that the requirements of IAS 19 are clear for the reasons set out in paragraphs 7, 11 and 18 of this paper, the staff recommends that the IFRIC not take this item on to its agenda.

20. Do you agree with the staff analysis and the wording for the agenda decision set out in appendix 1 of this paper?

Appendix 1: proposed wording for a tentative agenda decision

[Appendix 1 omitted from observer note.]

Appendix 2: the submission

There are some plans where employee contribution rates vary depending on the overall funding of the plan. For example, consider an arrangement where the cost of providing the benefits is generally split between the members and the employer in the ratio 40:60. If surpluses arise, these are often distributed in a similar manner, and current guidelines on surplus distribution include a requirement that at least 40% of any surplus distribution must be allocated to the members. One approach could be as follows:

- in a typical scheme, where members' contributions are fixed, member's contributions are deducted from the service cost. This, however, does not reflect the shared cost nature of this arrangement and instead an amount equal to 40% of the service cost is deducted.
- any surplus which is expected to be used to adjust members' benefits or contributions is treated as an addition to the liabilities. This addition is typically 40% of the disclosed surplus.
- where a deficit is revealed, account is taken of the additional contributions which it is expected will be required from members to finance the deficit. This is achieved by making a deduction from the liabilities typically of 40% of the total deficit.
- expected future surpluses in this shared cost scheme (essentially the difference between the expected return on assets and the interest cost) are treated in what we consider to be a consistent and prudent manner by assuming that 40% of such future surpluses would be used for the benefit of members, so only 60% is credited to the P&L. This is achieved by charging the P&L account with 60% of the interest cost and crediting it with 60% of the expected return on assets.

Would such an approach be acceptable under IAS19?

As an alternative, when there is a deficit, would it be acceptable to treat the future excess employee contributions analogously to a reimbursement right under paragraphs 104A and 104B?