Agenda ref 9

STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	IAS 19 *Employee Benefits*		
Paper topic	Measurement of the net DBO for post-employment benefit plans with employee contributions		
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Introduction

1. In September 2012, the IFRS Interpretations Committee (the Interpretations Committee) discussed a request seeking clarification of paragraph 93 of IAS 19 *Employee Benefits*. That paragraph refers to the accounting for contributions from employees to defined benefit plans. The Standard was issued in 2011 and will be effective from annual periods beginning on or after 1 January 2013. In this paper, we call IAS 19 issued in 2011 'IAS 19 (2011)' and IAS 19 issued in 1998 and currently effective 'IAS 19 (1998).'

2. The submitter is concerned that the guidance in paragraph 93 of IAS 19 (2011) would affect any plan with employee contributions, resulting in a change in measurement of the net defined benefit obligation (DBO) for all of those plans. The submitter thinks that this is an unintended consequence of the language in that paragraph.

3. At its September 2012 meeting[1], the Interpretations Committee tentatively observed that the proposals in the Exposure Draft for IAS 19 (2011), the IASB's decision at its meetings in February 2011 and the requirements in paragraph 93 of IAS 19 (2011) are consistent with each other. They all require that employee contributions, including expected future contributions resulting from employee service in the current and prior periods, should be considered in calculating the DBO.

4. Nonetheless, taking into account the general concern of the submitter and other interested parties—that it is not clear how to account for employee contributions—the Interpretations Committee asked the staff to bring to a future meeting some specific examples of how to account for employee contributions in accordance with paragraph 93 of IAS 19 (2011), so that the Interpretations Committee can decide how it should address this issue.

5. This agenda paper is organised as follows:

   (a) Summary of the issue

   (b) Another submission on the presentation of a net service cost

   (c) Staff analysis on the specific examples

   (d) Staff analysis on a defined benefit plan with 'salary sacrifice'

   (e) Staff analysis on the presentation issue

   (f) Staff recommendation

   (g) Appendix A—Specific examples analysed

   (h) Appendix B—Submission on the presentation issue.

Summary of the issue

6. Paragraph 93 of IAS 19 (2011) states (emphasis added):

> Contributions from employees or third parties set out in the formal terms of the plan either reduce service cost (if they are linked to service), or

[1] IFRIC Update September 2012: http://media.ifrs.org/IFRICUpdateSep12.htm

> reduce remeasurements of the net defined benefit liability (asset) (eg if the contributions are required to reduce a deficit arising from losses on plan assets or actuarial losses). **Contributions from employees or third parties in respect of service are attributed to periods of service as a negative benefit in accordance with paragraph 70** (ie the net benefit is attributed in accordance with that paragraph).

7. Paragraph 70 of IAS 19 (2011) states:

> In determining the present value of its defined benefit obligations and the related current service cost and, where applicable, past service cost, an entity shall attribute benefit to periods of service under the plan's benefit formula. However, if an employee's service in later years will lead to a materially higher level of benefit than in earlier years, an entity shall attribute benefit on a straight-line basis from:
>
> a) the date when service by the employee first leads to benefits under the plan (whether or not the benefits are conditional on further service) until
>
> b) the date when further service by the employee will lead to no material amount of further benefits under the plan, other than from further salary increases.

8. The submitter thinks that paragraph 93 of IAS 19 (2011) was intended to address measurement of the net DBO for plans in which the risk of plan deficits and/or surplus is shared with employees through their contributions to the plan. However, the submitter is concerned that the guidance would affect any plan with employee contributions, resulting in a change in measurement of the net DBO for virtually all of those plans. The submitter thinks that this is an unintended consequence of the language in paragraph 93 of IAS 19 (2011).

9. According to the submitter, in current practice under IAS 19 (1998), employee contributions reduce the gross service cost in the period in which they are received. Consequently, an employer’s current service cost is the total cost of benefits attributed to service in the current period, less the portion of that cost borne by employee contributions received in that period.

10. The submitter is concerned that, in periods in which the discount rate increases, employee contributions made in earlier periods have higher value, which may cause the net DBO to be back-loaded and increase the DBO. For example, the submitter thinks that, even very simple contributory plans with a benefit based on a level percent of pay and employee contributions also based on a level percent of pay may be considered back-loaded if, as is common, the salary growth rate is lower than the discount rate. This is because, after allowing for the effect of interest on employee contributions, the pattern of employee contributions will be front-loaded, causing the net benefit to be back-loaded.

11. The submitter is also concerned with the determination of the opening balance of the net DBO under IAS 19 (2011). An entity shall apply IAS 19 (2011) retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* other than in some exceptional cases, as set out in paragraph 173 of IAS 19 (2011). However, the submitter advocates that data on employees' past contributions may no longer exist to determine the effect on the net DBO of those contributions.

Other relevant paragraphs in IAS 19 (2011)

12. Paragraph 92 states that employee contributions either are set out as part of the formal terms of the plan or are discretionary:

> Some defined benefit plans require employees or third parties to contribute to the cost of the plan. Contributions by employees reduce the cost of the benefits to the entity. An entity considers whether third-party contributions reduce the cost of the benefits to the entity, or are a reimbursement right as described in paragraph 116. Contributions by employees or third parties are either set out in the formal terms of the plan (or arise from a constructive obligation that goes beyond those terms), or are discretionary. Discretionary contributions by employees or third parties reduce service cost upon payment of these contributions to the plan.

13. Paragraph 83 refers to the discount rate:

> The rate used to discount post-employment benefit obligations (both funded and unfunded) shall be determined by reference to market yields at the end of the reporting period on high quality corporate bonds. In countries where there is no deep market in such bonds, the market yields (at the end of the reporting period) on government bonds shall be used. The currency and term of the corporate bonds or government bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations.

14. Paragraph 114 refers to exclusion from plan assets:

> Plan assets exclude unpaid contributions due from the reporting entity to the fund, as well as any non-transferable financial instruments issued by the entity and held by the fund. Plan assets are reduced by any liabilities of the fund that do not relate to employee benefits, for example, trade and other payables and liabilities resulting from derivative financial instruments.

Another submission on the presentation of a net service cost

15. A few days before its September 2012 meeting, the Interpretations Committee received a submission on a presentation issue that relates to paragraph 93 of IAS 19 (2011) (see Appendix B for a full submission).

16. According to the submitter, if employee contributions are based on a fixed percentage of salary and the actuarial assumptions for discount rate and estimated future salary increases are not the same, the reduction in service cost that is due to employee contributions (ie negative service cost) will not equal the cash contribution in each period. The submitter asks how the difference between service cost and employee contributions should be presented in the financial statements.

17. At this meeting, the Interpretations Committee will be asked to consider specific examples of how to account for employee contributions in accordance with paragraph 93 of IAS 19 (2011). We think that it would be reasonable for the Interpretations Committee to also consider the presentation issue, in addition to the measurement issue, that could arise from the application of paragraph 93. The

first and second submitter both agreed with such approach. Consequently, we have included the staff analysis for the presentation issue in this paper.

Staff analysis on examples

18. We have analysed five examples as follows. The details are found in Appendix A.

    (a) **Example 1:** defined benefit plan without employee contributions

    (b) **Example 2:** defined benefit plan with employee contributions under current practice

    (c) **Example 3:** defined benefit plan with employee contributions under IAS 19 (2011), where the discount rate is higher than the salary growth rate

    (d) **Example 4:** defined benefit plan with employee contributions under IAS 19 (2011), where the discount rate is lower than the salary growth rate

    (e) **Example 5:** defined benefit plan with employee contributions under IAS 19 (2011), where the discount rate is the same as the salary growth rate.

19. The tables in the examples show how the obligation builds up for an employee who is expected to leave at the end of year 5, assuming that there are no changes in actuarial assumptions. For simplicity, the examples ignore the additional adjustment needed to reflect the probability that the employee may leave the entity at an earlier or later date. At the bottom of each example, we have included journal entries to account for service cost and DBO for year 1.

20. We have analysed the examples based on a view that the projected *amount* in monetary terms allocated to each period by the plan's benefit formula should be considered in assessing the benefit against the back-end loading test set out in paragraph 70 of IAS 19 (2011). Under this view, in our examples, although the plan's benefit formula attributes the same percentage of benefit to each year of service, the employee's service in later years is considered to lead to a materially

higher level of benefit than in earlier years because of the expected growth in salary in future years. In other words, the benefit is back-end loaded under the plan's benefit formula.

21. We acknowledge that there is another view that the percentage used for determining the benefit should be considered in assessing the benefit against the back-end loading test set out in paragraph 70 of IAS 19 (2011). Under this view, in our examples, the benefit is equal to 1 per cent of final salary for each year of service and thus the employee's service in later years will not lead to a materially higher level of benefit than in earlier years. In other words, the benefit is not back-end loaded but on a straight-line basis under the plan's benefit formula.

22. We note that the IASB discussed the effect of expected future salary increases on the attribution of benefits in the development of IAS 19 (2011), and that it decided not to address this issue. BC13 (c) of IAS 19 (2011) states:

> *The effect of expected future salary increases on the attribution of benefits*—The 2010 ED proposed that 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 to later years. The Board did not proceed with that proposal because it is closely related to a fundamental review of the accounting for contribution-based promises (see paragraphs BC117–BC120).

23. We accept that both interpretations are reasonable. We have chosen one in order to illustrate the accounting consequences of back-end loading, but this is not intended to express a preference for one over the other.

Example 1

24. This is the same example as 'Example illustrating paragraph 68' in IAS 19 (2011).

25. When an entity measures the DBO for a defined benefit plan without employee contribution, the entity shall attribute benefit to periods of service under the plan's benefit formula. In this example, a lump sum benefit is payable on termination of service and the benefit is equal to 1 per cent of final salary for each year of service. Because the employee's service in later years will lead to a materially

higher level of benefit than in earlier years, the entity shall attribute benefit on a straight-line basis in accordance with paragraph 70 of IAS 19 (2011).

26. Current service cost is the increase in the present value of the DBO resulting from employee service in the current period. Accordingly, the attributed benefit is discounted to the present value and is allocated as current service cost to each period. Because there is no employee contribution attached to the plan, the cost included in profit or loss is the entity's share and also the total cost of the total benefit.

27. The journal entry is to debit to service cost and credit to DBO.

Example 2

28. The only change from Example 1 is that employees are required to contribute in proportion to salary each year to the defined benefit plan.

29. According to the result of the outreach activities we conducted for the September 2012 meeting[2], the prevalent approach to account for employee contributions to defined benefit plans is to deduct the contributions from the gross service cost in the period in which they are received. In this example, we used that approach.

30. An entity discounts the attributed benefit to the present value and allocates it as current service cost to each period. Then the entity takes the actual contribution made for the year to subtract it from the current service cost in the year in which the contributions are received. The net amount for the year does not faithfully represent the entity's share in profit or loss because the contributions are outside the DBO measurement and thus the effect of expected future contributions that relate to past service is ignored.

31. The journal entries are to debit to service cost and credit to DBO to recognise gross service cost, and then to debit to plan asset and credit to service cost to reflect receipt of employee contributions.

[2] See Agenda Paper 10: http://www.ifrs.org/Meetings/Pages/IFRSInterSept12.aspx

Example 3

32. The assumptions used in this example are the same as those in Example 2. We use the approach under IAS 19 (2011) based on the Interpretations Committee's tentative observation at its September 2012 meeting, instead of the approach used in current practice.

33. In this example, the discount rate is higher than the salary growth rate.

34. An entity projects the amount of employee contributions receivable from year 1 to year 5 and calculates the future value of those contributions in the present by using the discount rate (projected total contributions). The purpose of that calculation is to estimate the expected growth of the funds contributed by employees over the period from the date of contribution to the date of retirement for each year's contributions. Because employee contributions are part of the DBO measurement, we think that, under most circumstances, the appropriate rate to project forward employee contributions is the rate used for the DBO (further analysis is found in the staff analysis below).

35. Because the higher discount rate (compared with the expected rate of growth of salaries) increases the value of employee contributions in earlier periods, the projected contributions as a negative benefit are front-end loaded, which leads to net benefits being back-end loaded. We think that attribution should be consistent between gross benefit and employee contributions to arrive at the net benefit, because using different attributions would result in distorting the measurement of a DBO. Consequently, the entity attributes the projected contributions on a straight-line basis so that the contributions are on the same basis as for the attributed benefit.

36. Current service cost is presented at the present value. Accordingly, the entity calculates the present value of the attributed contributions and subtracts it from the discounted (gross) current service cost to arrive at the (net) current service cost for the year.

37. The closing DBO balance in the statement of financial position is the total of the accumulation of the employer's share of cost, plus the contributions paid by the

employees. The net current service cost included in profit or loss is only the entity's share and not the total cost of the total benefit.

38. The journal entries are to debit to service cost and credit to DBO to recognise net current service cost (the amount described in paragraph 32 above), and then to debit to plan asset and credit to DBO to reflect receipt of employee contributions. Under the approach in IAS 19 (2011), the timing of the payment of employee contributions will not affect the timing of the recognition of the cost to the employer.

Example 4

39. The assumptions used in this example, including the accounting approach, are the same as those in Example 3, except that the discount rate is lower than the salary growth rate.

40. Because the higher rate of salary increase increases the value of employee contributions in later periods, the projected contributions as a negative benefit are back-end loaded, which leads to net benefits being front-end loaded. As stated already, attribution should be consistent between gross benefit and employee contributions to arrive at the net benefit. Consequently, the entity attributes the projected contributions on a straight-line basis so that the contributions are on the same basis as for the attributed benefit.

Example 5

41. The assumptions used in this example, including the accounting approach, are the same as those in Example 3 and 4, except that the discount rate is the same as the salary growth rate.

42. Because the discount rate is the same as the salary growth rate, the effect between those rates cancels out to give a straight-line result that matches the basis for attributed benefit. In other words, the projected contributions are neither front-end nor back-end loaded. Consequently, attributing the projected contributions on a straight-line basis is not necessary.

Staff analysis

43. As shown in the examples, the rate of salary increases and the discount rate act as opposing forces on the pattern of employee contributions. Higher discount rates increase the value of employee contributions in earlier periods (ie front-end loaded as illustrated in Example 3). Higher rates of salary increases increase the value of employee contributions in later periods (ie back-end loaded as illustrated in Example 4).

44. We think that the approach under IAS 19 (2011) well depicts the economics of such an interaction, because a higher discount rate increases the value of contributions in the present compared to a benefit to be paid in the future, while a higher rate of salary increase increases the value of future contributions. This arises because of the projected unit credit method and the attribution requirements.

45. The DBO is the ‘present value’ of expected future payments required to settle the obligation resulting from employee service in the current and prior periods and, therefore, reflects the time value of money. In our view, the appropriate rate to project forward employee contributions is the rate used for the DBO because employee contributions are part of the DBO measurement. Under most circumstances, this should be the same rate that is used to discount the attributed amounts to present value (ie the rate required under paragraph 83 of IAS 19 (2011), however a different rate might be appropriate if the benefits are projected forward because of a link to asset returns—in such a case using an expected rate of return might be appropriate). We note that the Interpretations Committee is considering an issue on contribution-based-promises as part of another submission, and there may be an interaction with the appropriate discount rate to use as a result of that discussion.

46. As stated already, we think that attribution should be consistent between gross benefit and employee contributions to arrive at the net benefit, because using different attributions result in distorting the measurement of a DBO. In other words, if the gross benefit is attributed on a straight-line basis because of a

materially higher level of benefit in later years, employee contributions should also be attributed on a straight-line basis.

47. In Examples 3 to 5, we note that the same result will be obtained if net benefit (total gross benefit minus projected total contributions) is discounted using the discount rate to arrive at the net current service cost for each year. For example, in Example 3, if we subtract projected total contributions of CU347 from gross benefit of CU655 and attribute the difference to each year using the discount rate of 10%, the net current service cost would be CU42, 46, 51, 56 and 62 for each year. If actual contributions are added to those amounts, they will be the increase in DBO for each year as shown in Example 3.

48. This is because, in Examples 3 to 5, we simply allocate to each year the present value of expected future payments (including those arising from employee contributions resulting from past service) required to settle the employer's obligation. If attribution basis used for employee contributions is different from attribution basis used for gross benefit, the result obtained will not be the same.

49. Deducting the contributions from the gross service cost in the period in which they are received, as seen in current practice (Example 2), does not cause any interaction arising from the difference in rates and is therefore a straightforward approach. This approach would be consistent with the view that employee contributions are deductions from current salary and should be attributed the same as current salary. In essence, IAS 19 (2011) takes the opposite view by stating that employee contributions are deductions from future defined benefit payments and, therefore, should be attributed the same as those benefits. Consequently, the issue arises because of the different attribution requirements for salaries and for defined benefits (further analysis is found on this in the staff analysis on 'salary sacrifice' below).

50. As we stated in the staff paper for the September 2012 meeting, the measurement of the DBO should include (the present value of) those future contributions by employees that relate to employee service before the reporting date. In Example 2, the employee contributions are outside the DBO measurement and thus the effect of expected future contributions that relate to past service is ignored. In our view, this is not a faithful representation of the expense incurred by the entity.

Contributions by employees reduce the cost of the benefits to the entity, however, the timing of payment of employee contributions should not affect the timing of recognition of service costs in the entity's profit or loss. This is reflected in the accounting illustrated in Examples 3 to 5.

Retrospective application

51. We acknowledge that there are general concerns about the retrospective application. In order to apply the requirements of IAS 19 (2011) retrospectively, an entity has to make estimate of the life of the scheme of employee contributions, from the commencement date of the scheme up to retirement date as of the transition date. This may cause a difficulty because some entities might have maintained a defined benefit plan for decades and data on employees' past contributions may no longer exist.

52. However, we think that entities may make reasonable estimates in meeting the requirements of Standards. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their ability to represent faithfully an entity's financial position and financial performance.

Staff analysis on 'salary sacrifice'

53. A defined benefit plan may involve an arrangement, where an employee receives a reduced salary, in return for an increase in the employer's contributions to the defined benefit plan (salary sacrifice).

54. The existence of salary sacrifice can transform a plan from a plan with employee contributions to a plan with no employee contributions, without an overall change in employee remuneration or cost to the entity. However, the accounting requirements for pension costs and the accounting requirements for salary costs are different. This could lead to a different pattern of cost recognition, although total cost to the entity over the life of the employee is the same.

55. Assume an arrangement with the following terms for a year:

- Salary CU50,000

- Benefit CU5,000
- Salary reduction of CU2,000 contributed to the plan (‘salary sacrifice)’
- Net salary paid to an employee is CU48,000

There are two views as to how to account for the salary sacrifice.

View A: The salary sacrificed by the employee is, in substance, an employee contribution to defined benefit plan

56. Proponents of this view think that the salary sacrifice is in substance an employee contribution to a defined benefit plan. Consequently, the amount recognised as salary expense should be the salary gross of the amount sacrificed, and the amount sacrificed should be separately accounted for as an employee contribution.

View B: The salary sacrificed by the employee is a negative short-term employee benefit

57. Proponents of view think that the salary sacrifice is a negative short-term benefit because net salary including the salary sacrifice is settled in the year. Short-term employee benefits are defined in IAS 19 (2011) as employee benefits (other than termination benefits) that are expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service. Proponents of this view think that the employee has a lower salary and, therefore, the defined benefit plan is non-contributory.

Staff analysis

58. The journal entries under View A would be:

Dr	Salary	50,000	
	Cr Cash		50,000[3]
Dr	Service cost	3,000	

[3] This consists of payment of 48,000 to employee and 2,000 to plan assets

	Cr DBO		3,000
Dr	Plan asset	2,000[4]	
	Cr DBO		2,000

59. The journal entries under View B would be:

Dr	Salary	48,000	
Dr	Plan asset	2,000	
	Cr Cash		50,000
Dr	Service cost	5,000	
	Cr DBO		5,000

60. In both views, the amount recognised in profit or loss is CU53,000 and the DBO is CU5,000. However, service cost under View A is CU3,000 while CU5,000 under View B (although the service cost under View B is offset by a reduced salary expense so net effect to profit or loss is the same).

61. The salary sacrifice is part of the salary (as a negative effect to the employee) but at the same time part of the benefit (as a positive effect to the employee). We note that the amount reduced from the employee's salary as salary sacrifice is added to the funding of the total benefits paid to the employee. This means that the employer bears the same total cost of the total benefits paid to the employee, irrespective of whether the deduction from salary is classified as a reduced gross salary with no employee contribution to the plan, or a higher gross salary with an employee contribution to the plan.

62. Consequently, we support View A that salary sacrifice is in substance an employee contribution to a defined benefit plan.

63. We note that paragraph 92 of IAS 19 (2011) states that employee contributions either are set out as part of the formal terms of the plan or are discretionary, and that discretionary contributions reduce service cost upon payment. This paragraph, in effect, distinguishes between those contributions that should be

[4] Salary reduction of CU2,000 contributed to the plan

accounted for as current salary (because those benefits have essentially vested and the employee decided to contribute them voluntarily), and those that should form part of the measurement of the defined benefit (because the employee has no option but accept deferral of receipt of benefits into the future).

Staff analysis on presentation of a net service cost

64. The submitter of this issue states that, as a consequence of applying paragraph 93 of IAS 19 (2011), there arises a difference between service cost (net of the projected and attributed employee contributions) and actual employee contributions received for the year. The question raised by the submitter is how the difference should be presented in the financial statements. There are four views.

View A: as an adjustment to the DBO

65. Proponents of this view think that, because the difference results from a requirement to account for employee contributions as part of the service cost for a plan, it should be reflected in the DBO for that plan.

View B: as an adjustment to plan assets

66. Paragraph 114 of IAS 19 (2011) requires various liabilities, including trade and other payables, to be deducted from the value of plan assets. Proponents of this view think the treatment of trade and other payables might be seen as the closest analogy to a ‘prepaid’ employee contribution.

View C: as a separate balance

67. Proponents of this view do not think that the difference meets the definition of either a DBO or of a plan asset and, therefore, should be presented separately from both.

View D: alternative view

68. According to the proponents of this view, the difference does not exist if the 'as paid' basis of accounting is applied. They think that that only the increase in future contributions should be considered as negative benefit and thus that the full value of employee contributions received should be credited to service cost. This is because the pattern of funding from employee contributions should not affect the DBO arising from past and current service.

Staff analysis

69. We agree with View A. The difference arises because employee contributions are included in the DBO measurement. As illustrated in Examples 3 to 5, an entity calculates the present value of the projected contributions in the DBO measurement, which may or may not be different from the undiscounted actual contributions received for the year.

70. Employee contributions (linked to employee service) are part of the funding of the total benefits paid to employees and, therefore, employee contributions should increase the employer's gross obligation to the employees. Accordingly, we think that the difference should be part of the adjustment to the DBO.

71. We disagree with View B. Plan assets consist of cash paid to the plan and, therefore, should not include the difference arising from the DBO measurement. Paragraph 114 of IAS 19 (2011) states that plan assets are reduced by any liabilities of the fund that do **not** relate to employee benefits. Employee contributions do relate to employee benefits.

72. We disagree with View C. Presenting the difference separately from the DBO in the statement of financial position would not be appropriate. As stated already, employee contributions should increase the employer's gross obligation to the employees.

73. We disagree with View D. The difference is a consequence of including employee contributions in the DBO measurement, which needs to be accounted for as an adjustment to the DBO. The employer's exposure to obligations to the

plan will not decrease even if employee contributions are accounted for as a negative benefit. Instead, the employer's obligations will increase because the employer owes the total benefits, including those funded by employee contributions, to its employees.

Staff recommendation

74. On the basis of the analysis above, we recommend that the Interpretations Committee should add additional guidance to clarify the application of paragraph 93 of IAS 19 (2011) and that the staff use the specific examples (Examples 3 to 5) in this paper as a basis on which to develop such guidance.

75. We think that the guidance should be provided in the form of implementation guidance to IAS 19 (2011) rather than as part of the annual improvements. This is because, although we think that our proposal is explanatory in nature, as opposed to changing the requirements, the importance of this guidance is such that it should be developed and exposed following a timetable that is dependent only on the work needed for this amendment, rather than be based on the annual improvements timeline which would likely take longer.

Question for the Interpretations Committee

Question for the Interpretations Committee
(1) Does the Interpretations Committee agree with the staff analysis on:
a) specific examples in Appendix A to this paper;
b) a defined benefit plan with 'salary sacrifice'; and
c) the submission on presentation?
(2) Does the Committee agree with the staff recommendation?

Appendix A—Examples analysed

The tables in the examples show how the obligation builds up for an employee who is expected to leave at the end of year 5, assuming that there are no changes in actuarial assumptions. For simplicity, the examples ignore the additional adjustment needed to reflect the probability that the employee may leave the entity at an earlier or later date. At the bottom of each example, we have included journal entries to account for service cost and DBO for year 1.

Note:

- The opening obligation is the present value of the benefit attributed to prior years.
- The current service cost is the present value of the benefit attributed to the current year.
- The closing obligation is the present value of the benefit attributed to current and prior years.
- Currency amounts are denominated in ‘currency units’ (CU).

Example 1: defined benefit plan without employee contributions

A lump sum benefit is payable on termination of service and equal to 1 per cent of final salary for each year of service.

The salary in year 1 is CU10,000 and is assumed to increase at 7 per cent (compound) each year.
The discount rate used is 10 per cent per year.

Year	1	2	3	4	5	Total	
	CU	CU	CU	CU	CU		
Salary	10,000	10,700	11,449	12,250	13,108		
Benefit attributed to:							
– prior years	-	131	262	393	524		
– current year (1% of final salary)	131	131	131	131	131		straight-lined per paragraph 70
– current and prior years	131	262	393	524	655		
Gross benefit							
Opening obligation	-	90	197	325	477		
Interest at 10%	-	9	20	32	48	109	
Current service cost	90	98	108	119	131	547	entity's share in profit or loss
Closing obligation	90	197	325	477	655		

Journal entries (for Year 1)

Dr Service cost 90
Cr Defined benefit obligation 90

Example 2: defined benefit plan with employee contributions under current practice

A lump sum benefit is payable on termination of service and equal to 1 per cent of final salary for each year of service.

The salary in year 1 is CU10,000 and is assumed to increase at 7 per cent (compound) each year.
The discount rate used is 10 per cent per year.

Employees are required to contribute 0.5% of salary each year.

Year	1	2	3	4	5	Total	
	CU	CU	CU	CU	CU		
Salary	10,000	10,700	11,449	12,250	13,108		
Benefit attributed to:							
– prior years	-	131	262	393	524		
– current year (1% of final salary)	131	131	131	131	131		straight-lined per paragraph 70
– current and prior years	131	262	393	524	655		
Gross benefit							
Opening obligation	-	90	197	325	477		
Interest at 10%	-	9	20	32	48	109	
Current service cost (a)	90	98	108	119	131	547	
Closing obligation	90	197	325	477	655		
Employee contributions (b)	(50)	(54)	(57)	(61)	(66)	(288)	
Current service cost (a) - (b)	40	45	51	58	66	259	

Journal entries (for Year 1)

To recognise gross service cost

Dr Service cost 90
Cr Defined benefit obligation 90

To reflect receipt of employee contributions

Dr Plan assets 50
Cr Service cost 50

Example 3: defined benefit plan with employee contributions under IAS 19 (2011), where the discount rate is higher than the salary growth rate

A lump sum benefit is payable on termination of service and equal to 1 per cent of final salary for each year of service.

The salary in year 1 is CU10,000 and is assumed to increase at 7 per cent (compound) each year.
The discount rate used is 10 per cent per year.

Employees are required to contribute 0.5% of salary each year.

Year	1	2	3	4	5	Total	
	CU	CU	CU	CU	CU		
Salary	10,000	10,700	11,449	12,250	13,108		
Benefit attributed to:							
– prior years	-	131	262	393	524		
– current year (1% of final salary)	131	131	131	131	131		straight-lined per paragraph 70
– current and prior years	131	262	393	524	655		
Gross benefit							
Opening obligation	-	90	197	325	477		
Interest at 10%	-	9	20	32	48	109	
Current service cost (a)	90	98	108	119	131	547	
Closing obligation	90	197	325	477	655		
Employee contributions							
Actual contributions	(50)	(54)	(57)	(61)	(66)	(288)	
Projected total contributions	(73)	(71)	(69)	(67)	(66)	(347)	: future-valued contributions
Attributed contributions	(69)	(69)	(69)	(69)	(69)	(347)	: straight-lined to be on the same basis with the attributed benefit
Opening	-	(47)	(104)	(172)	(252)		
Interest at 10%	-	(5)	(10)	(17)	(25)	(58)	
Negative benefit (b)	(47)	(52)	(57)	(63)	(69)	(288)	
Closing	(47)	(104)	(172)	(252)	(347)		: present value of attributed contributions
Opening obligation	-	92	201	330	480		
Interest at 10%	-	9	20	33	48	110	
Current service cost (a) - (b)	42	46	51	56	62	258	: entity's share in profit or loss
Actual Contributions	50	54	57	61	66	288	
Closing obligation	92	201	330	480	655		

Net benefit (gross benefit minus projected total contributions) is attributed to each year using the discount rate

	1	2	3	4	5	Total	
Current service cost	42	46	51	56	62	258	: present value of gross benefit minus projected total contributions

Journal entries (for Year 1)

To recognise net service cost

Dr Service cost 42
Cr Defined benefit obligation 42

To reflect receipt of employee contributions

Dr Plan assets 50
Cr Defined benefit obligation 50

Example 4: defined benefit plan with employee contributions under IAS 19 (2011), where the discount rate is lower than the salary growth rate

A lump sum benefit is payable on termination of service and equal to 1 per cent of final salary for each year of service.

The salary in year 1 is CU10,000 and is assumed to increase at 7 per cent (compound) each year.
The discount rate used is 4 per cent per year.

Employees are required to contribute 0.5% of salary each year.

Year	1	2	3	4	5	Total	
	CU	CU	CU	CU	CU		
Salary	10,000	10,700	11,449	12,250	13,108		
Benefit attributed to:							
– prior years	-	131	262	393	524		
– current year (1% of final salary)	131	131	131	131	131		straight-lined per paragraph 70
– current and prior years	131	262	393	524	655		
Gross benefit							
Opening obligation	-	112	233	364	504		
Interest at 4%	-	4	9	15	20	49	
Current service cost (a)	112	117	121	126	131	607	
Closing obligation	112	233	364	504	655		
Employee contributions							
Actual contributions	(50)	(54)	(57)	(61)	(66)	(288)	
Projected total contributions	(58)	(60)	(62)	(64)	(66)	(310)	: future-valued contributions
Attributed contributions	(62)	(62)	(62)	(62)	(62)	(310)	: straight-lined to be on the same basis with the attributed benefit
Opening	-	(53)	(110)	(172)	(238)		
Interest at 4%	-	(2)	(4)	(7)	(10)	(23)	
Negative benefit (b)	(53)	(55)	(57)	(60)	(62)	(288)	
Closing	(53)	(110)	(172)	(238)	(310)		: present value of attributed contributions
Opening obligation	-	109	228	359	501		
Interest at 4%	-	4	9	14	20	48	
Current service cost (a) - (b)	59	61	64	66	69	320	: entity's share in profit or loss
Actual Contributions	50	54	57	61	66	288	
Closing obligation	109	228	359	501	655		

Net benefit (gross benefit minus projected total contributions) is attributed to each year using the discount rate

	1	2	3	4	5	Total	
Current service cost	59	61	64	66	69	320	: present value of gross benefit minus projected total contributions

Journal entries (for Year 1)

To recognise net service cost

Dr Service cost 59
Cr Defined benefit obligation 59

To reflect receipt of employee contributions

Dr Plan assets 50
Cr Defined benefit obligation 50

Example 5: defined benefit plan with employee contributions under IAS 19 (2011), where the discount rate is the same as the salary growth rate

A lump sum benefit is payable on termination of service and equal to 1 per cent of final salary for each year of service.

The salary in year 1 is CU10,000 and is assumed to increase at 7 per cent (compound) each year.
The discount rate used is 7 per cent per year.

Employees are required to contribute 0.5% of salary each year.

Year	1	2	3	4	5	Total	
	CU	CU	CU	CU	CU		
Salary	10,000	10,700	11,449	12,250	13,108		
Benefit attributed to:							
– prior years	-	131	262	393	524		
– current year (1% of final salary)	131	131	131	131	131		straight-lined per paragraph 70
– current and prior years	131	262	393	524	655		
Gross benefit							
Opening obligation	-	100	214	343	490		
Interest at 7%	-	7	15	24	34	80	
Current service cost (a)	100	107	114	123	131	575	
Closing obligation	100	214	343	490	655		
Employee contributions							
Actual contributions	(50)	(54)	(57)	(61)	(66)	(288)	
Projected total contributions	(66)	(66)	(66)	(66)	(66)	(328)	: future-valued contributions
Attributed contributions	(66)	(66)	(66)	(66)	(66)	(328)	: The effect between the discount rate and the salary growth rate cancels out to give a straight line result
Opening	-	(50)	(107)	(172)	(245)		
Interest at 7%	-	(4)	(7)	(12)	(17)	(40)	
Negative benefit (b)	(50)	(54)	(57)	(61)	(66)	(288)	
Closing	(50)	(107)	(172)	(245)	(328)		: present value of attributed contributions
Opening obligation	-	100	214	343	490		
Interest at 7%	-	7	15	24	34	80	
Current service cost (a) - (b)	50	54	57	61	66	288	: entity's share in profit or loss
Actual Contributions	50	54	57	61	66	288	
Closing obligation	100	214	343	490	655		

Net benefit (gross benefit minus projected total contributions) is attributed to each year using the discount rate

	1	2	3	4	5	Total	
Current service cost	50	54	57	61	66	288	: present value of gross benefit minus projected total contributions

Journal entries (for Year 1)

To recognise net service cost

Dr Service cost 50
Cr Defined benefit obligation 50

To reflect receipt of employee contributions

Dr Plan assets 50
Cr Defined benefit obligation 50

Appendix B—Submission on the presentation issue

All information has been copied without modification, except for one to keep the submitter anonymous.

Mr Wayne Upton
Chairman
IFRS Interpretations Committee
30 Cannon Street
London
United Kingdom
EC4M 6XH

Email: ifric@ifrs.org

10 September 2012

Dear Mr Upton,

Suggested agenda item: Treatment of service linked employee contributions to a defined benefit scheme under IAS 19(2011)

It has come to our attention that there are divergent views on the appropriate treatment under the 2011 version of IAS 19 (‘IAS 19R’) of service linked contributions made by employees to a defined benefit scheme and are seeking clarification of this issue by the Committee.

We recognise that a submission has been received on this topic, and was included in the Committee’s Work in Progress summary for it meeting in July 2012, but believe that the scope of the Committee’s considerations should be extended to include the presentation issue described below.

The Issue

Prior to its amendment in 2011, IAS 19 gave only indirect guidance (confirmed by an IFRIC agenda rejection decision in November 2007) on the treatment of employee contributions to defined benefit plans. Based on this guidance in and ‘around’ the Standard, employee contributions linked to service (for example, a percentage of salary deducted at source and paid into the plan) were deducted from current service costs on an ‘as paid’ basis.

However, paragraph 93 of IAS 19R introduced a requirement that “contributions from employees or third parties in respect of service are attributed to periods of service as a negative benefit in accordance with paragraph 70 (ie the net benefit is attributed in accordance with that paragraph).”

If employee contributions are based on a fixed percentage of salary and the actuarial assumptions for discount rate and estimated future salary increases are not equal, the

reduction in service cost due to employee contributions ('negative service cost') will not equal the cash contribution in each period (specifically, if the salary growth assumption is lower than the discount rate, employee contributions will exceed negative service cost early in the service period).

For example, assume that the gross service cost for a certain period is CU1,000 and that the negative service cost as calculated under IAS 19R.70 is CU100, but that the amount contributed by the employee amounts to CU120. The entries would be:

	CU
Dr Service cost	1,000
Cr Defined benefit obligation (DBO)	1,000
Dr Plan assets	120
Cr Current service costs	100
Cr [Difference between service cost and employee's contribution]	20

How should the difference between service cost and employee contributions be classified?

Based on an analysis that the reference in IAS 19R.93 to paragraph 70 and the Board's discussion of employee contributions in IAS 19R.BC150(a) leave no scope to apply a different method of calculation and that, therefore, a difference may frequently arise between the cash contributed by an employee and the negative service cost calculated using the projected unit credit method, the question then arises of how to classify such a difference.

The possible classifications appear to be:

As an adjustment to the DBO (increasing its value in the example above)

Proponents of this view believe that as the difference results from a requirement to account for employee contributions as part of the service cost for a plan it should be reflected in the DBO for that plan and that contributions paid by an employee in advance of their recognition within service costs could be seen as increasing the plan's liability to the employee (and as such should be added to that obligation).

As an adjustment to plan assets (decreasing their value in the example above)

Proponents of this view believe that adjusting the DBO for this difference would lead to a distortion of that liability by introducing something other than the discounted value of contributions payable but that as the difference is a function of the plan it should be presented with other balances integral to the plan.

Paragraph 114 of IAS 19R requires various liabilities be deducted from the value of plan assets and the treatment of 'trade and other payables' might be seen as the closest analogy to a 'prepaid' employee contribution. However, this could be seen as distorting the value of plan assets by effectively not recognising part of the cash paid to the plan in respect of

employee contributions (or, at least, the assets that case was used to purchase) when these do meet the definition of plan assets.

As a separate balance (a liability for 'prepaid employee contributions' in the example above)

Proponents of this view do not believe that a difference between negative service cost and employee contributions meets the definition of either a DBO or a plan asset and therefore should be presented separately from both. However, this could result in a balance that is entirely a function of the plan being presented elsewhere in the statement of financial position and would necessitate consideration of whether this balance meets the general definition of an asset or a liability

Proponents recognise that all possible classifications are, to some extent, problematic and would seek guidance from the Committee on this issue.

Alternative view

We are also aware of an alternative view that the difference referred to above does not exist as the 'as paid' basis of accounting can be applied based on an argument that only the increase in future contributions should be considered as negative benefit and thus that the full value of employee contributions received should be credited to service costs as they believe that the pattern of funding from employee contributions should not affect the defined benefit obligation arising from past and current service. Proponents of this view believe that the value of the defined benefit obligation should not be *increased* (as might frequently be the case as discount rates typically exceed salary growth expectations in many jurisdictions) by a risk sharing arrangement which *decreases* the employer's exposure to obligations from future service.

Proponents also believe that the negative benefit as mentioned in IAS 19R.93 should be determined as the present value of the future increases in employee contributions. If these contributions are linked to salary, the part of the DBO that reflects the impact of future salary increases will be funded by both employer and employee. By deducting past service period related units of this negative benefit from the DBO, the portion of future employee contributions that is linked to future salary increases is attributed to the service period in the same way as the future salary increases are resulting in 'as paid' accounting.

Reason for IFRIC to Address the Issue

We believe that this issue should be addressed in a timely manner as service linked employee contributions are a common feature of defined benefit plans in many jurisdictions and, based on discussions in some of those jurisdictions, we believe that diversity in practice is likely to arise in the absence of further guidance.

We further believe that this issue should be addressed in a timely manner as it will be relevant to financial statements prepared in 2013.