



## STAFF PAPER

January 2013

### IFRS Interpretations Committee Meeting

<b>Project</b>	<b>IAS 19 <i>Employee Benefits</i></b>
<b>Paper topic</b>	Measurement of the net DBO for post-employment benefit plans with employee contributions
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in *IFRIC Update*. The approval of a final Interpretation by the Board is reported in *IASB Update*.

### Introduction

1. In May 2012, the IFRS Interpretations Committee (the Interpretations Committee) received a request seeking clarification of paragraph 93 of IAS 19 *Employee Benefits*. That paragraph refers to the accounting for employee contributions set out in the formal terms of a defined benefit plan. The Standard is effective from annual periods beginning on or after 1 January 2013. The Interpretations Committee discussed this issue at its September and November 2012 meetings.
2. This paper discusses the classification of employee benefits that involve employee contributions to a defined benefit plan. The structure of this paper is as follows:
  - (a) summary of the issue;
  - (b) the Interpretations Committee’s discussions to date;
  - (c) staff analysis; and
  - (d) staff recommendation for the next step.

## Summary of the issue

3. The Interpretations Committee received two submissions in relation to paragraph 93 of IAS 19. The paragraph 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 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).

4. The first submitter was concerned<sup>1</sup> that:

- (a) the guidance in paragraph 93 of IAS 19 would affect any plan with employee contributions, resulting in a change in measurement of the defined benefit obligations (DBO) for virtually all of those plans.
- (b) as a result of applying the requirements in paragraph 93 of IAS 19, attribution of employee contributions fluctuate between front-loaded and back-loaded if the attribution changes due to changes in assumptions such as the relationship between the discount rate and the salary growth rate.
- (c) retrospective application of IAS 19 might be difficult because data on employees' past contributions may no longer exist to determine the effect on the DBO of those contributions.

5. The second submitter stated<sup>2</sup> that 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

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<sup>1</sup> See Agenda Paper 10 for September 2012 meeting for a full submission:  
<http://www.ifrs.org/Meetings/Pages/IFRSInterSept12.aspx>

<sup>2</sup> See Agenda Paper 9 for November 2012 meeting for a full submission:  
<http://www.ifrs.org/Meetings/Pages/IFRSInterNov012.aspx>

contribution in each period. The second submitter asked how the difference between service cost and employee contributions should be presented in the financial statements.

### **The Interpretations Committee's discussions to date**

6. At its September 2012 meeting<sup>3</sup>, the Interpretations Committee tentatively observed that the proposals in the Exposure Draft for IAS 19, the IASB's decision at its meetings in February 2011 and the requirements in paragraph 93 of IAS 19 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.
7. At its November 2012 meeting<sup>4</sup>, the Interpretations Committee considered a number of examples illustrating the application of the requirements and the effect of different discount rate and salary growth assumptions on the calculation of the net benefit. The Interpretations Committee agreed with the staff analysis that the calculations illustrated are in line with the requirements for employee contributions in respect of service that are set out in paragraph 93 of IAS 19.
8. At the November 2012 meeting we presented to the Interpretations Committee an analysis on an arrangement for a defined benefit plan, where an employee receives a reduced salary, in return for an increase in the employer's contributions to the defined benefit plan. The Interpretations Committee was concerned that even a very simple contributory plan (ie a fixed percentage of salary) would be subject to a complex calculation for attributing the benefits to periods of service. The Interpretations Committee observed that some employee contributions, such as contributions related to service rendered in the same period, should be classified as a reduction in short-term employee benefits and would therefore not be within the scope of paragraph 93 of IAS 19.

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<sup>3</sup> IFRIC Update September 2012: <http://media.ifrs.org/IFRICUpdateSep12.htm>

<sup>4</sup> IFRIC Update November 2012: <http://media.ifrs.org/2012/IFRIC/IFRIC-Update-November-2012.htm>

9. Accordingly, at this meeting, the Interpretations Committee will discuss the classification of employee benefits that involve employee contributions to a defined benefit plan (ie whether such contributions reduce short-term employee benefits cost or whether they reduce post-employment benefits cost) by considering some examples where an employee is required to contribute to a defined benefit plan.

**Staff analysis on the classification of employee benefits that involve employee contributions to a defined benefit plan**

10. Assume the following examples:
- (a) Example 1:
- (i) salary of CU<sup>5</sup>50,000 for the first year, subject to future salary increases.
  - (ii) defined benefit of 10% of salary, ie CU5,000 for the first year.
  - (iii) employee contributions of **a fixed percentage of 4% of salary**, ie CU2,000 for the first year, deducted from the salary and contributed to the defined benefit plan.
  - (iv) net salary paid to an employee is CU48,000 for the first year, and defined benefit of CU5,000 paid after employment.
- (b) Example 2:
- (i) employee contributions are **4% of salary for the first ten years and then increase to 6% thereafter in accordance with the terms of the plan.**
  - (ii) other assumptions are the same as those in Example 1.

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<sup>5</sup> Currency amounts are denominated in ‘currency units’ (CU) in this paper.

**View A: short-term employee benefits**

11. Proponents of this view think that the employee contributions in both Examples are a reduction in short-term employee benefit because the net salary, reduced by required contributions, is settled in the year. Proponents of this view think that, in substance, the employee has a lower salary and, therefore, the defined benefit plan is non-contributory (ie the short-term employee benefit cost is reduced by the contributions whereas the post-employment benefit cost is not).
12. The journal entries under this View for the first year would be:

Dr	Salary		CU48,000
Dr	Plan asset		CU2,000 <sup>6</sup>
	Cr	Cash	CU50,000
Dr	Service cost		CU5,000
	Cr	DBO	CU5,000

**View B: post-employment benefits**

13. Proponents of this view think that the employee contributions in both Examples are contributions to a defined benefit plan. This is because the amount reduced from the employee's salary is added to the funding of the total benefits paid to the employee that are paid after the employee's retirement (ie the post-employment benefit cost is reduced by the contributions whereas the short-term employee benefit cost is not).
14. The journal entries under this View for the first year would be:

Dr	Salary		CU50,000
	Cr	Cash	CU50,000 <sup>7</sup>
Dr	Service cost		CU3,000

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<sup>6</sup> Salary reduction of CU2,000 contributed to the plan

<sup>7</sup> This consists of payment of CU48,000 to employee and CU2,000 to plan assets

	Cr	DBO	CU3,000
Dr	Plan asset	CU2,000	
	Cr	DBO	CU2,000

### **Staff analysis**

15. The classification of employee benefits as either short-term employee benefits or post-employment benefits determines how they are recognised and measured. Economically the benefits are the same regardless of classification.
16. Paragraph 8 of IAS 19 defines short-term employee benefits and post-employment benefits as follows:

*Short-term employee benefits* are 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.

*Post-employment benefits* are employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment.

17. If the employee contributions are classified as a reduction in short-term employee benefits, the net benefits (ie reduced salary) will be measured at the undiscounted amount of the benefits expected to be paid, and recognised in the period of service in accordance with Paragraph 11 of IAS 19.
18. If the employee contributions are classified as part of post-employment benefits, the contributions will be classified as either contributions to defined contribution plans or contributions to defined benefit plans. Because the issue submitted involves employee contributions to a defined benefit plan, the obligations for the cost of the benefits including (net of) the employee contributions will be measured on a discounted basis, and attributed to periods of service as a negative benefit, in accordance with the steps identified in paragraph 57 of IAS 19 that describes recognition and measurement for defined benefit plans.

19. An important criterion to classify employee benefits as a reduction in short-term employee benefits is whether the benefits are expected to be settled within twelve months after the related service. If the benefits are payable after the completion of the employment, the benefits are classified as post-employment benefits.
20. View A is based on the following line of thinking. The employer pays a net salary of CU48,000 to the employee in exchange for the employee's service for that year. In other words, the employer effectively settles benefits to the employee for that year at the net amount of salary.
21. On the other hand, the defined benefits of CU5,000 will be paid after completion of the employment. The contributions are 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). In other words, the contributions are a transfer from one benefit to the other. This is the underlying logic for View B.
22. We think that an entity should look at the substance of the transaction in determining the classification. The defined benefits are only paid after retirement. However, if the contributions are linked to each year's service, the employee's salary could be considered to be settled with a reduced net amount in exchange for the employee's service for that year.
23. In our view, this approach can be applied to Example 1. Employee contributions in Example 1 are a fixed percentage of salary, which means that the contributions are in proportion to salary and thus linked solely to the employee's service rendered each year.
24. We do not think that employee contributions in Example 2 are linked solely to each year's service. This is because the stepped increase in the percentage of employee contributions, based on the terms of the plan, results in higher contributions in the latter years that could be considered linked to service in earlier years. In Example 2, the increase to 6% is not only related to the service in the current year, but also related to the first ten years' service, which is a prerequisite for the change in contribution percentage. In other words, employee contributions are not settled in the period in which the employee's service is rendered.

25. A clear example of employee contributions that are not linked solely to the employee's service rendered in the same period in which they are paid is employee contributions to post-employment medical benefits. Such benefits typically require an employee to contribute to the medical costs covered by the plan at the time the employee visits medical institutions, not necessarily at the same time as the service is rendered. For such benefits, it is clearly necessary to attribute the net benefit to periods of service as a defined benefit.
26. Consequently, we think that employee contributions are classified as a reduction in short-term employee benefits and are accounted for as such if:
- (a) the contributions are linked solely to the employee's service rendered in the same period; and
  - (b) the contributions 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.
27. If we apply the approach above, employee contributions in Example 1 will be accounted for as a reduction in short-term employee benefits because the contributions are linked solely to the employee's service rendered in the same period and settled in that period. Employee contributions in Example 2 will be accounted for as post-employment benefits, because attributing the contributions to periods of service in accordance with the requirements of recognition and measurement for defined benefit plans better reflects the underlying economics.
28. We note that post-employment benefits are defined as benefits *other than* short-term employee benefits (and termination benefits) that are payable after the completion of employment. In other words, short-term employee benefits have precedence over post-employment benefits in the hierarchy of definitions. Accordingly, employee contributions are first tested against the definition of short-term employee benefits. If the employee contributions do not meet the definition of short-term employee benefits (and termination benefits), an entity shall apply the requirements for post-employment benefits, including paragraph 93.



**Other considerations**

29. Paragraph 93 of IAS 19 refers to employee contributions linked to service or in respect of service as follows:
- (a) contributions from employees set out in the formal terms of the plan either reduce service cost (if they are *linked to service*)...
  - (b) contributions from employees *in respect of service* are attributed to periods of service as a negative benefit...
30. We do not think that these two phrases are intended to have different meanings. Instead, both of the phrases are intended to mean that contributions that are linked to service should be distinguished from those that reduce remeasurements of the net defined benefit liability (asset).
31. Because the way they are worded may cause confusion in distinguishing between employee contributions that are classified as a reduction in short-term employee benefits (based on our analysis) and those that are accounted for under paragraph 93, we think we need to clarify that employee contributions set out in paragraph 93 are contributions that are classified as post-employment benefits.
32. In other words, the contributions that are required to be attributed to periods of service as a negative benefit in accordance with paragraph 93 are ones that are neither linked solely to the employee's service rendered in the same period nor expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service.

**Staff recommendation**

33. In this paper, we have analysed that some employee contributions are accounted for as a reduction in short-term employee benefits if they meet the definition for short-term employee benefits. In addition, at the November meeting, we analysed some examples of how to attribute employee contributions in respect of service that are classified as post-employment defined benefits to periods of service as a negative benefit in accordance with paragraph 93 of IAS 19.

34. We think that there are four options for how to address this analysis:
- (a) Option 1: reject the issue because IAS 19 is clear
  - (b) Option 2: issue an interpretation of IAS 19
  - (c) Option 3: amend IAS 19 to make the requirements clearer
  - (d) Option 4: provide implementation guidance supporting IAS 19
35. We do not recommend Option 1 because the definitions of short-term employee benefits and post-employment benefits are not sufficiently clear to ensure that all entities reach the same interpretation as we do in this paper. In addition, we think that providing specific examples would be useful in the accounting for employee contributions that are within the scope of paragraph 93.
36. We do not recommend Option 2. Although the staff analysis on the classification is interpretative in nature, we think it useful to provide specific examples of attributing benefit and those examples fit well in the form of implementation guidance rather than an interpretation. Moreover, guidance should be developed in a timeline that is shorter than that of issuing an interpretation because the standard is effective for annual periods beginning on or after 1 January 2013.
37. We do not recommend Option 3 because the staff analysis in this paper is interpretative in nature as opposed to changing the requirements.
38. Consequently, we recommend that the Interpretations Committee should choose Option 4 and provide guidance in the form of implementation guidance. The guidance should include:
- (a) employee contributions are classified as a reduction in short-term employee benefits and are accounted for as such if:
    - (i) the contributions are linked solely to the employee's service rendered in the same period; and
    - (ii) the contributions are expected to be settled (eg deducted from salary) wholly before twelve months after the end of the annual reporting period in which the employees render the related service.

- (b) employee contributions classified as post-employment benefits and then classified as contributions to defined benefit plans should be attributed to periods of service as a negative benefit as described in paragraph 93, unless they reduce remeasurements of the net defined benefit liability. Specific examples of attributing benefit will be added. We note that the fact pattern used in the examples in the November staff paper should be modified because employee contributions in those examples assumed a fixed percentage of salary, which are classified as short-term employee benefits based on our analysis in this paper.
39. We note that we have already assessed this issue against the agenda criteria of the Interpretations Committee in the staff paper for the September 2012 meeting. We have identified that this issue is widespread and there are significant divergent interpretations.

### Question for the Interpretations Committee

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Does the Interpretations Committee agree with the staff analysis and recommendation on the classification of employee benefits that involve employee contributions to a defined benefit plan?