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STAFF PAPER

12–13 November 2013

IFRS Interpretations Committee Meeting

Project	**IAS 19 *Employee Benefits***		
Paper topic	Scope—Employee benefit plans with a guaranteed return on contributions or notional contributions		
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Introduction

1. In the July 2013 meeting, the Interpretations Committee tentatively confirmed the characteristics of the employee benefit plans that fall within the scope of this project. One of the characteristics is that the benefit under the plans is not dependent on future events (for example, salary changes, vesting or demographic risk). This means that benefit promises that depend on future events, such as benefit promises with vesting conditions, would be outside the agreed scope.

2. In September 2013, the Interpretations Committee tentatively agreed to reconsider whether benefit promises with vesting conditions should be within the agreed scope.

3. Benefit promises with vesting conditions are an example of benefit promises that depend on future events. Arguably, all benefit promises that are not defined contribution plans depend on future events and, therefore, we think that the Interpretations Committee should delete the reference to future events in the agreed scope. Thus, in this paper, we limit the analysis to whether the agreed scope should include or exclude benefit promises with vesting conditions, demographic risks and salary risks.

4. This paper recommends that benefit promises with vesting conditions and demographic risks should be within the scope of the project, and benefit promises with salary risk should remain beyond the scope of this project.

Vesting conditions

Application of the projected unit credit method

5. Some benefit promises are subject to vesting conditions. In other words, the employees will not receive any benefits unless they satisfy specified conditions, usually relating to length of service.

6. Employee benefit plans with a guaranteed return on contributions or notional contributions do not meet the definition of defined contribution plans in IAS 19 and thus the plans would be classified as defined benefit plans in IAS 19. Defined contribution plans and defined benefit plans are defined in IAS 19 as follows:

> *Defined contribution plans* are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.
>
> *Defined benefit plans* are post-employment benefit plans other than defined contribution plans.

7. Consequently, exclusion of benefit promises with vesting conditions from the agreed scope means that employee benefit plans with a guaranteed return on contributions or notional contributions with vesting conditions would be accounted for in accordance with the requirements for defined benefit plans under IAS 19.

8. The projected unit credit method in IAS 19 requires the benefit to be projected forward at an expected rate of return on the assets or index and discounted to a present value using the rate specified in IAS 19 (ie rate on high quality corporate bonds or government bonds). However, unless the benefit is based on the return on high quality corporate bonds or government bonds, that discount rate would

not measure the benefits correctly. This is because the discount rate does not reflect the risk of the assets and the use of any other specific discount rate would result in similar problems.

9. In other words, exclusion of benefit promises with vesting conditions from the agreed scope would not address the problem and would result in different accounting for promises that would be similar except for the existence of vesting conditions.

Distinction between vested benefits and unvested benefits

10. For defined benefit promises, IAS 19 does not distinguish between vested benefits and unvested benefits. Paragraph 72 of IAS 19 states that 'employee service gives rise to an obligation under a defined benefit plan even if the benefits are conditional on future employment (in other words they are not vested)'. Accordingly, an entity uses the projected unit credit method to attribute benefit to periods of service, regardless of whether that benefit is vested or unvested.

11. We acknowledge that excluding benefit promises with vesting conditions from the agreed scope narrows the scope and lessens the need to set out requirements for unvested benefits. However, we think that benefit promises should be accounted for in the same way, regardless of whether they are vested or unvested. An entity should consider vesting conditions when measuring the obligation, instead of when determining the classification of the benefit. In our view, this would be more consistent with the existing treatment of vesting conditions in IAS 19.

12. In addition, an anomaly would arise if benefit promises with vesting conditions were excluded from the agreed scope. Assume a benefit promise that is unvested for the first ten years and then vested afterwards. If benefit promises with vesting conditions were excluded from the agreed scope, the benefit promise would be accounted for as a defined benefit plan for the first ten years and then accounted for as a plan within the agreed scope of this project for the remaining periods. In other words, the accounting for the first ten years would be different from that of the remaining periods, although the benefit promise is the same. We think that this is confusing and would cause unnecessary complexity.

Conclusion

13. Consequently, we think that benefit promises with vesting conditions should be within the agreed scope of the Interpretations Committee's work.

Question 1
Does the Interpretations Committee agree that benefit promises with vesting conditions should be within the agreed scope of the Interpretations Committee's work?

Demographic risks

14. Demographic risk is the risk that the liability for benefits promised to a group of beneficiaries will fluctuate because of changes in the characteristics of the members of that group. For example, longevity risk is the risk that the liability increases because beneficiaries live for longer than expected. Below is an example of a benefit promise with longevity risk:

> The employer promises to contribute into a separate fund 5 per cent of the employee's salary for each year of service. The lump sum at retirement, which is equal to the accumulated contributions plus the investment returns they earn, is converted into a pension at a fixed annuity rate. That pension amount is payable in monthly instalments for the life of the retired employee.

15. We note that the main reason why the Interpretations Committee decided to address employee benefit plans with a guaranteed return on contributions or notional contributions was to resolve problems with the application of the projected unit credit method in IAS 19 to those plans (see paragraph 8 of this paper). If benefits with demographic risks were precluded from the agreed scope, then the accounting for benefits that include a guaranteed return on contributions or notional contributions **and** demographic risks would not be resolved.

16. In addition, demographic risks arise from various assumptions featured in the benefit promise. Paragraph 76 of IAS 19 states that demographic assumptions deal with matters such as;

(a) mortality;

(b) rates of employee turnover, disability and early retirement;

(c) the proportion of plan members with dependants who will be eligible for benefits;

(d) the proportion of plan members who will select each form of payment option available under the plan terms; and

(e) claim rates under medical plans.

17. We acknowledge that the Interpretations Committee intended to make the scope as narrow as possible but also to address as many plans as possible to respond to the ongoing concerns about the accounting. In other words, the Interpretations Committee's objective is to strike the right balance.

18. Excluding benefit promises with demographic risks from the agreed scope means that a benefit promise would be scoped out if the promise contains even one demographic assumption. In our view, this would result in scoping out a number of plans.

19. Consequently, we think that benefit promises with demographic risks should be within the agreed scope of the Interpretations Committee's work.

Question 2
Does the Interpretations Committee agree that benefit promises with demographic risks should be within the agreed scope of the Interpretations Committee's work?

Salary risks

20. Salary risk is the risk that the liability for benefits promised will change because of changes in future salaries. Salary risks can be seen in final salary plans and some promises that average salary over a defined number of future years. Below are examples of such promises:

> [Example 1] The benefit is a lump sum at retirement equal to 5 per cent of the employee's final salary at retirement for each year of service.

[Example 2] The benefit is a lump sum at retirement equal to 5 per cent of the average of the employee's final three years' salary before retirement, for each year of service.

21. In IAS 19, those plans do not meet the definition of defined contribution plans and thus they are classified as defined benefit plans in IAS 19. To the best of our knowledge, there have been no significant issues about application of the projected unit credit method to those plans.

22. If the Interpretations Committee included those plans (with salary risk) in its agreed scope, that would result in an unnecessary change of accounting for those plans and will include almost all existing defined benefit plans within the agreed scope.

23. Consequently, we recommend that benefit promises with salary risks should be outside the agreed scope of the Interpretations Committee's work.

Question 3
Does the Interpretations Committee agree that benefit promises with salary risks should be outside the agreed scope of the Interpretations Committee's work?

Question 4
Does the Interpretations Committee agree that the agreed scope should delete the exclusion of plans that are subject to future events other than salary risks?