

Effect of a Potential Discount on Plan Classification (IAS 19 *Employee Benefits*)—June 2019

The Committee received a request about the classification of a post-employment benefit plan applying IAS 19. In the fact pattern described in the request, an entity sponsors a post-employment benefit plan that is administered by a third party. The relevant terms and conditions of the plan are as follows:

- a. the entity has an obligation to pay fixed annual contributions to the plan. The entity has determined that it will have no legal or constructive obligation to pay further contributions if the plan does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.
- b. the entity is entitled to a potential discount on its annual contributions. The discount arises if the ratio of plan assets to plan liabilities exceeds a set level. Thus, any discount might be affected by actuarial assumptions and the return on plan assets.

The request asked whether, applying IAS 19, the existence of a right to a potential discount would result in a defined benefit plan classification.

Paragraph 8 of IAS 19 defines defined contribution plans as ‘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’.

Paragraphs 27–30 of IAS 19 specify requirements relating to the classification of post-employment benefit plans as either defined contribution plans or defined benefit plans.

Paragraph 27 states that ‘[p]ost-employment benefit plans are classified as either defined contribution or defined benefit plans, depending on the economic substance of the plan as derived from its principal terms and conditions’. The Committee therefore noted the importance of assessing all relevant terms and conditions of a post-employment benefit plan, as well as any informal practices that might give rise to a constructive obligation, in classifying the plan. That assessment would identify whether:

- a. the entity’s legal or constructive obligation towards employees is limited to the amount that it agrees to contribute to the fund (a defined contribution plan as described in paragraph 28); or
- b. the entity has an obligation to provide the agreed benefits to current and former employees (a defined benefit plan as described in paragraph 30).

The Committee noted that, in the fact pattern described in the request, assessing the relevant terms and conditions of the plan would include, for example, assessing (a) the manner and frequency in which annual contributions and any potential discount (including the target ratio) are determined; and (b) whether the manner and frequency of determining the contributions and any discount transfers actuarial risk and investment risk (as described in IAS 19) to the entity.

The Committee observed that, to meet the definition of a defined contribution plan, an entity must (a) have an obligation towards employees to pay fixed contributions into a fund; and (b) not be obliged to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current or prior periods. For example, there should be no possibility that future contributions could be set to cover shortfalls in funding employee benefits relating to employee service in the current and prior periods.

The Committee also observed that paragraphs 28 and 30 of IAS 19 specify that, under defined contribution plans, actuarial risk and investment risk fall in substance on the employee whereas, under defined benefit plans, those risks fall in substance on the entity. Paragraphs 28 and 30 describe (a) actuarial risk as the risk

that benefits will cost the entity more than expected or will be less than expected for the employee; and (b) investment risk as the risk that assets invested will be insufficient to meet expected benefits. Paragraph BC29 of IAS 19 explains that the definition of defined contribution plans does not exclude the upside potential that the cost to the entity may be less than expected.

Consequently, the Committee concluded that, applying IAS 19, the existence of a right to a potential discount would not in itself result in classifying a post-employment benefit plan as a defined benefit plan. Nonetheless, the Committee reiterated the importance of assessing all relevant terms and conditions of a plan, as well as any informal practices that might give rise to a constructive obligation, in classifying the plan.

The Committee noted that, applying paragraph 122 of IAS 1 *Presentation of Financial Statements*, an entity would disclose the judgements that its management has made regarding the classification of post-employment benefit plans, if those are part of the judgements that had the most significant effect on the amounts recognised in the financial statements.

The Committee concluded that the requirements in IAS 19 provide an adequate basis for an entity to determine the classification of a post-employment benefit plan as a defined contribution plan or a defined benefit plan. Consequently, the Committee decided not to add the matter to its standard-setting agenda.