Project **IAS 19 *Employee Benefits***

Topic **Defined contribution plans with vesting conditions**

Objective and introduction

1. The objective of this Agenda Paper is to provide the IFRS Interpretations Committee (the Committee) with an update on the staff's research and analysis to date on the Committee's outstanding issue Employee Benefits*:* Defined contribution plans with vesting conditions (see Agenda Paper 11 for the March 2011 Committee Meeting[1]). In addition, the staff are seeking to obtain preliminary views and guidance from the Committee to assist them.

2. This Agenda Paper includes:

   (a) background information of the issue;

   (b) a staff analysis to date;

   (c) staff recommendations on the next steps; and

   (d) questions for the Committee.

Background

3. In February 2011, the Committee received a submission seeking clarification on the impact that vesting conditions have upon the accounting for defined

[1] http://www.ifrs.org/NR/rdonlyres/8A0E58B4-FA91-47C3-9C2E-87A9B531F7D2/0/111103AP11IFRSInterpretationsCommitteeIssuesListMar11.pdf

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRS Interpretations Committee or the IASB. 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*.

Interpretations are published only after the IFRS Interpretations Committee and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

contribution plans. Are contributions to such a plan recognised as an expense in the period they are paid for or recognised over the vesting period?

4. The submission gives two examples:

First example:

5. An entity makes contributions to a defined contribution plan in respect of its employees. If the employee leaves within two years of commencing service with the entity, he or she is not entitled to any benefits under the plan and the contributions are refunded to the entity.

6. The submission then asks whether the contributions paid in year one should be considered:

   (a) due for service solely in year one; or

   (b) due in part for service in year one and in part for service in year two, ie the remaining vesting period.

Second example:

7. The second example is a more complex one: Contributions are paid to the plan in respect of each employee each year:

Vesting condition	*Vested interest in the accumulated contributions*
Employment terminates after age 60	100%
Employment terminates after age 55	75%
Employment terminates before age 55	50%

8. The submission then asks whether a year's contributions should be considered as relating solely to service before the end of the reporting period in which the contribution is made or, alternatively, for an employee below 60 years of age, should the contribution be recognised in part over the period through to the age of 55 or 60, depending on the employee's current age?

9. The submitter does not give its own views but indicates two possible analyses:

   (a) any attribution of contributions to a future period of vesting might be seen as somewhat of a contradiction of the statement in paragraph 43 of IAS 19 *Employee Benefits* that accounting for defined contribution plans is straightforward;

   (b) the words in paragraph 44(a) of IAS 19 suggest that it is necessary to identify the contributions due for service before the end of the reporting period, in such a way that any excess contribution may properly be recognised as a prepayment if the asset recognition criteria are met (including the ways set out in that paragraph).

10. For ease of reference, the text of the submission is reproduced in Appendix A to this paper.

Staff analysis to date

Current requirements

11. Paragraph 7 of IAS 19 gives a definition of defined contribution plans:

> 7. […] *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. [...]

12. This definition is supported by the following explanation in paragraph BC5 of IAS 19:

> BC5. The old IAS 19 defined:
>
> (a) **defined contribution plans** as retirement benefit plans under which amounts to be paid as retirement benefits are determined by reference to contributions to a fund together with investment earnings thereon; and
>
> (b) **defined benefit plans** as retirement benefit plans under which amounts to be paid as retirement benefits are determined by reference to a formula usually based on employees' remuneration and/or years of service.
>
> The Board considers these definitions unsatisfactory because they focus on the benefit receivable by the employee, rather than on the cost to the entity. The

> definitions in paragraph 7 of the new IAS 19 focus on the **downside risk** that the cost to the entity may increase. The definition of defined contribution plans **does not exclude the upside potential** that the cost to the entity may be less than expected.

13. Paragraph 43 of IAS 19 outlines the accounting for defined contribution plans before paragraphs 44 and 45 of IAS 19 give the main recognition and measurement principles for defined contribution plan accounting:

> 43. **Accounting for defined contribution plans is straightforward** because the reporting entity's obligation for each period is determined by the amounts to be contributed for that period. **Consequently, no actuarial assumptions are required to measure the obligation or the expense and there is no possibility of any actuarial gain or loss.** Moreover, the obligations are measured on an undiscounted basis, except where they do not fall due wholly within twelve months after the end of the period in which the employees render the related service.
>
> 44. When an employee has rendered service to an entity during a period, the entity shall recognise the contribution payable to a defined contribution plan in exchange for that service:
>
> (a) as a liability (accrued expense), after deducting any contribution already paid**. If the contribution already paid exceeds the contribution due for service before the end of the reporting period,** an entity shall recognise that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund; and
>
> (b) as an expense, unless another Standard requires or permits the inclusion of the contribution in the cost of an asset (see, for example, IAS 2 and IAS 16).
>
> 45. Where contributions to a defined contribution plan do not fall due wholly within twelve months after the end of the period in which the employees render the related service, they shall be discounted using the discount rate specified in paragraph 78.

14. These accounting requirements are supported by the following explanation in paragraph BC6 of IAS 19:

> BC6. The new IAS 19 does not change the accounting for defined contribution plans, which is straightforward because there is no need for actuarial assumptions and an entity has no possibility of any actuarial gain or loss. The new IAS 19 gives no guidance equivalent to paragraphs 20 (past service costs in defined contribution plans) and 21 (curtailment of defined contribution plans) of the old IAS 19. The Board believes that these issues are not relevant to defined contribution plans.

Post-employment benefits project

15. Considering the Board's discussions and tentative decisions taken in the post-employment benefit project we do not expect the forthcoming amendments to IAS 19 to change these requirements.

Preliminary staff views

16. In our opinion, there are two issues that have to be differentiated:
    (a) The first one is the classification of plan as a 'defined contribution plan' or as a 'defined benefit plan'.
    (b) The second issue is the recognition and the measurement of the liability and the expense for a defined contribution plan.

Classification

17. We conclude from the definition of a defined contribution plan in paragraph 7 of IAS 19 and the explanation in BC5 of IAS 19 that only 'downside risks' for the employer preclude the classification of a plan as a defined contribution plan. 'Upside potential', ie that the cost to the employer are less than expected, instead is irrelevant for the classification of plan as a defined contribution plan.
18. Consequently, vesting conditions do not have an impact upon the classification of plan as a defined contribution plan, if the employer benefits from refunds or reduced future contributions if the vesting conditions are not met. Such plans are classified as defined contribution plans, as long as the employer is not required to make additional contributions to cover shortfalls.
19. From the above, we agree with the submitter that the schemes presented in the request meet the definition of defined contribution plans and have to be classified accordingly.

Recognition and measurement

20. Paragraph 43 of IAS 19 characterises the accounting for defined contribution plans as straightforward because the reporting **entity's obligation for each period** is determined by the **amounts to be contributed for that period** and concludes from this that no actuarial assumptions are required to measure **the obligation** or the expense.

21. We understand from this guidance in paragraph 43 of IAS 19 that accounting for defined contribution plans is accounting for the reporting entity's **obligation** to pay contributions **to the separate entity** which runs the scheme but **not** for the **obligation to the employees** who benefit from the scheme.

22. In other words, contributions to defined benefit plans are expensed or recognised as a liability (accrued expense) when they fall due and the service rendered by an employee during the period is only the event that obligates the employer to pay the contribution to the separate entity according to the terms and conditions of the scheme.

23. Correspondingly, paragraph 44 of IAS 19 requires the entity to recognise **contributions payable to a defined contribution plan** in exchange for the service rendered by the employee during a period.

24. From the above, we conclude that the potential for refunds is simply the 'upside potential', as contemplated in paragraph BC5 of IAS 19 and such refunds do not represent contributions for future service or prepayments as contemplated in paragraph 44(a) of IAS 19. Instead, the refunds are recognised as an asset and income when the entity/employer becomes entitled to it, eg the employee failing to meet the vesting condition.

25. We acknowledge that paragraph 44(a) of IAS 19 might be read that a vesting condition may require an entity to identify the portion of contributions paid that is attributable to the service rendered by the employee in the current period and the portion of contributions paid that is attributable to future service and

therefore a prepayment. However, we do not think this is the intention of this paragraph.

Outreach request

26. We have undertaken an outreach to the National Standard Setters group to determine whether:

    (a) *The issue is widespread and has practical relevance.*

    (b) *The issue indicates that there are significant divergent interpretations (either emerging or existing in practice).*

    (c) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*

27. To address these criteria we sent out a request for information to the National Standard Setters group.

28. The request included Appendix C to Agenda Paper 11 for the March 2011 Committee Meeting[2] and the questions asked to the National Standard Setters group, were as follows:

> 1. What is the prevalence of this issue in practice in your experience?
>
> 2. What is the diversity in accounting for such plans you see in practice?
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> If these types of plans are common, I would greatly appreciate it if you could also provide further information about terms and conditions of such plans and a summary of the accounting that you observe. In particular, do you observe these plans being classified as 'defined contribution plans' or 'defined benefit plans' in accordance with IAS 19?

[2] http://www.ifrs.org/NR/rdonlyres/8A0E58B4-FA91-47C3-9C2E-87A9B531F7D2/0/111103AP11IFRSInterpretationsCommitteeIssuesListMar11.pdf

29. The request was still outstanding when this agenda paper was completed. We will provide the Committee with an update of the results of this outreach at the May Committee meeting.

Staff recommendations

30. If the Committee agrees with our technical analysis (see paragraphs 16-25 of this paper), our recommendation on next steps depends on the results of the outreach:

    (a) if it turns out that the issue satisfies the criteria listed in paragraph 26 of this paper, we will propose that the Committee recommends to the Board a clarification of the recognition and measurement requirements for defined contribution plans in paragraph 44 of IAS 19.

    (b) if it turns out however that the issue does not satisfy the criteria listed in paragraph 26 of this paper, we will recommend that the Committee should not add the issue to its agenda.

31. If the Committee agrees with our recommendation, we would present a discussion of the outreach results together with either a draft tentative agenda decision or a proposed amendment for the annual improvements project at the July Committee meeting.

Questions for the Committee

Questions for the Committee
1. Does the Committee agree with our technical analysis in paragraphs 16-25? 2. Does the Committee agree with our recommendation in paragraph 31?

Appendix A—Interpretations Committee potential agenda item request

The staff received the following request. All information has been copied without modification, except for details that would identify the submitter of the request and details that are subject to confidentiality.

IAS 19: Defined contribution plans with vesting conditions

The issue:

There is diversity in practice about the impact of vesting conditions on the timing of recognition as an expense of contributions made to a defined contribution plan.

IAS 19 *Employee benefits* paragraph 43 contains the following text: "accounting for defined contribution plans is straightforward because the reporting entity's obligation for each period is determined by the amounts to be contributed for that period. …"

Paragraph 44 of the standard sets out the recognition requirements for contributions to defined contribution plans:

When an employee has rendered service to an entity during a period, the entity shall recognise the contribution payable to a defined contribution plan in exchange for that service:

(a) as a liability (accrued expense), after deducting any contribution already paid. If the contribution already paid exceeds the contribution due for service before the end of the reporting period, an entity shall recognise that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund; and

(b) as an expense, unless another Standard requires or permits the inclusion of the contribution in the cost of an asset (see, for example, IAS 2 Inventories and IAS 16 Property, Plant and Equipment).

The words of paragraph 44 (a) suggest that it is necessary to identify the contribution due for service before the end of the reporting period, such that any excess contribution may properly be recognised as a prepayment if the asset recognition criteria are met (including in the ways set out in that paragraph).

For example, an entity makes contributions to a defined contribution plan in respect of its employees. If the employee leaves within two years of commencing service with the entity, he is not entitled to any benefits under the plan and the contributions are refunded to the entity. Should the contributions paid in year one be considered (i) due for service solely in year one; or (ii) due in part for service in year one and in part for service in year two, the remaining vesting period?

In a more complex example:

Vesting condition	*Vested interest in the accumulated contributions*
Employment terminates after age 60	100%
Employment terminates after age 55	75%
Employment terminates before age 55	50%

Contributions are paid to the plan in respect of each employee each year. Should a year's contributions be considered as relating solely to service before the end of the reporting period in which the contribution is made? Or, alternatively, for an employee below 60 years of age should the contribution be spread in part over the period through to the age of 55 or 60, depending on his current age?

Any attribution of contributions to a future period of vesting might be seen as somewhat of a contradiction of the statement in paragraph 43 that accounting for defined contribution plans is straightforward.

Current practice:

We understand that various types of defined contribution plan with vesting conditions exist around the world. We understand further that the accounting treatment of contributions made to such plans varies, in some cases being expensed in the year that they are made and in other cases being spread over a vesting period.

The views of the large networks of accounting firms are understood to be mixed. For example, the published guidance of one includes an example in which amounts are forfeited by participants who leave the entity before vesting and revert to the employer. The conclusion, without consideration of the possibility of forfeiture, is that all of the contributions relate to service before the end of the reporting period and that the entire amount of the contributions therefore should be expensed in the year that they are made. The published guidance of another gives the second example shown above and states that the contributions should be spread over the period of vesting.

Reasons for the Interpretations Committee to address the issue:

We believe that:

- This issue is widespread and practical, particularly in view of a general shift globally from defined benefit to defined contribution plans.
- As noted above, it involves significantly divergent interpretations, both emerging (as further countries move to adopt IFRSs) and already existing in practice.
- Financial reporting would be improved through elimination of this diversity.
- The issue is sufficiently narrow in scope as to be capable of resolution within the confines of IFRSs and the *Framework for the Preparation and Presentation of Financial Statements* but not so narrow that it is inefficient to seek to resolve it.
- The IASB has stated that it does not intend to commence a comprehensive review of IAS 19 at this stage. In the Basis for Conclusions to ED/2010/3 it stated that it "will not begin further work on future phases of this project until after mid-2011 [and] has made

no tentative decisions about the scope and directions of any such future phases. Consequently, any decisions made in [the ED/2010/3 phase] will remain in place for several years."