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**International  
Accounting Standards  
Board**

*This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.*

*These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.*

### **INFORMATION FOR OBSERVERS**

**Board Meeting:** 12 December 2006, London

**Project:** IAS 19 *Employee Benefits*

**Subject:** Cash balance and similar plans (Agenda Paper 4)

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#### **Introduction**

1. The Board agreed to address the accounting requirements for cash balance and similar plans in Phase I of the *Employee Benefits* project. This short paper provides a high level overview of possible approaches the Board could take in determining the most appropriate accounting treatment for these types of plans, and the scope of this aspect of the project.
2. A more detailed consideration of the issues will be considered at subsequent meetings. The discussion in this paper should be used as a starting point for thinking about the approaches with the aim of clarifying the approach or approaches the Board would like to develop further.

#### **Summary of the scope issue**

3. IAS 19 *Employee Benefits* prescribes the accounting for all forms of consideration given by an entity in exchange for service rendered by employees. In this paper, we will address the accounting for post-employment benefit plans only.

4. IAS 19 identifies two main categories of post-employment benefits: defined benefit (DB) and defined contribution (DC) plans.
5. DC plans are plans where the *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 have sufficient assets to pay all employee benefits relating to employee service in current and prior service periods.*
6. A typical example of this would be a 401 (k) plan in the US where contributions are paid on behalf of the employee and the employee assumes the investment risk in the plan. There is no risk to the entity.
7. DB plans are all plans that are not DC, ie where the entity assumes some downside risk. A typical example of this would be a final salary plan that promises a pension benefit equal to 2% of final salary for each year of employee service.
8. The defined benefit obligation in respect of DB plans is measured using the projected unit credit (PUC) method. This approach requires the entity to project the amount of benefit that would be payable at retirement (based on accrued service) and discount this amount at the yield on AA corporate bonds to determine the present value, at the balance sheet date, of the defined benefit obligation. (It is sometimes referred to as the project and discount approach).
9. For DC plans, the net liability of the entity is nil. In essence, the implied measurement of the plan obligation for a DC plan is assumed to be equal to the market value of the assets in the plan.
10. For some time, typical DB and DC plans were very common. However, during the 1980's and 1990's there was a significant shift away from traditional DB and DC plans to plans which have both DB and DC features as well as other guarantees. As discussed below and as illustrated in the educational session in October, such plans are difficult to account for under IAS 19. The problem is identifying which plans or benefits we should be trying to address in this aspect of the project, and which we should be leaving until phase two.
11. Despite the wide variety of plans in existence, the staff notes that post-employment benefits can be analysed into three groups:

- (a) salary based benefits, eg a benefit of 2% of final salary for each year of service
- (b) asset based benefits, eg a benefit of contributions plus the return on the assets in the plan
- (c) other benefits that do not depend on salary or assets (for example fixed lump sums or post-employment medical care).

12. This analysis focuses solely on the benefit promise. The staff does not think that the funding (or not) of the plan is relevant at this point.
13. The staff notes that a plan may offer a combination of types of benefit, for example the higher of a final salary based benefit and a fixed lump sum. Such plans are discussed in paragraph 16 and 17 below.
14. The staff also notes that, for the purposes of this initial discussion, contributions based on salary are not regarded as salary based benefits. So for example, a benefit of a contribution of 5% of current salary each year plus the actual return on the assets in which the contribution is invested (ie a typical DC plan) would be regarded as an asset based benefit. The reason for this classification is that, once the contributions have been accrued, the benefit is no longer dependent on salary. This classification has implications that will be discussed at a later meeting.
15. The staff thinks that the Board's decision to leave the measurement of typical final salary plans until phase two of the project implies that group (a) should not be part of the scope of this aspect of the project. Group (c) also causes no particular problems under the PUC method (other than the problems that arise with final salary plans that will be dealt with in phase two). The staff therefore argues that group (c) should not be part of the scope of this aspect of the project.
16. Group (b), benefits that are asset based, are the benefits that cause the most obvious problems, as discussed below. Further, to cover all the problems with asset based benefits, the staff thinks we also need to look at all plans that offer a combination of asset based benefits and other benefits. An example is a plan that offers a benefit of a lump sum equal to contributions together with the

actual return on the assets (an asset based benefit, in fact a typical DC plan) with a guaranteed return of at least 0% (a fixed benefit).

17. A question yet to be resolved is whether we want to address combinations of non-asset based benefits, for example a plan that offers the higher of a final salary benefit and a fixed lump sum. Some staff would argue that these combinations have been around since FAS 87 and IAS 19 were first developed and their accounting has not caused problems in practice. They should not therefore be the main focus of our attention here. On the other hand, other staff argue that the current accounting can materially understate the liability in some cases. In addition, the staff also notes that it may be possible to deal with the optionality in question relatively simply in at least one of the approaches discussed below. If that is the case, and that approach finds favour with the Board, perhaps we should apply it to combinations of non-asset based benefits.
18. The paper now outlines the main problems in applying IAS 19 to asset based benefits and possible approaches to resolving those problems. Those approaches involve different ways of separating out asset based benefits from other benefits.

#### **Problems with asset based benefits**

19. Many plans with benefits that are asset based are DB plans under the definitions in IAS 19 because they create downside risk for the entity. So, for instance, under the current definitions there can be no such thing as an “unfunded DC plan” ie an unfunded plan that provides a benefit equal to fixed notional contributions in line with notional investment earnings. This is because the entity bears the investment risk.
20. The staff believes that the accounting for a plan should be neutral with respect to its funding. In other words, the plan liability for plans that provide the same benefit promise should be the same, regardless of how it is funded. However, under current IAS 19 requirements, an unfunded DC plan as described above would be classified as DB and would therefore be accounted for differently from its funded DC counterpart.
21. There are two reasons for this. Firstly, the plan obligation in respect of a DC plan is effectively measured at fair value while the obligation in respect of a DB plan is not. Also, the PUC method is typically interpreted as a deterministic

‘project and discount’ method which does not allow for consistency in the assumptions used to project the benefit compared with the assumptions used to discount the benefit which is fixed to the yield on AA corporate bonds.

22. A further problem arises if a plan offers a combination of benefits. Consider a benefit of contributions plus the actual return on assets in the plan, with a guarantee of at least 0%. The guarantee makes the plan DB under IAS 19. But applying the PUC to such a plan is difficult and does not give the same result as treating the plan in what seems the obvious way, ie as a DC plan with an embedded guarantee.
23. The educational session in October gave further examples of the problems in applying IAS 19 to asset based benefits.

### **Possible solutions**

24. The staff has considered the following approaches:

- (a) the approach in the draft IFRIC Interpretation D9: *Employee Benefits with a Promised Return on Contributions or Notional Contributions*
- (b) an embedded derivative approach and
- (c) a deconstruction approach.

### *D9: Employee Benefits with a Promised Return on Contributions or Notional Contributions*

25. The proposals in D9 did not discuss the issue in terms of asset based benefits. To summarise them using that terminology, the staff would say that D9 proposed an approach which essentially split the benefit into an asset based benefit and a non asset based benefit. The non asset based benefit was treated in accordance with DB accounting under IAS 19. The plan liability for the asset based benefit was measured at the fair value of the underlying assets. No value was attributed to any optionality between benefits. For example, consider a benefit of a lump sum equal to the higher of (i) contributions plus the actual return and (ii) contributions plus a fixed return. The total plan liability would just be either the amount resulting from DB accounting for the fixed return or the fair value of the assets in the plan, whichever were the higher at the balance sheet date.

26. Respondents to D9 raised concerns that:

- (a) the approach did not measure the value of any optionality in the benefits and
- (b) for some asset based benefits it would be difficult to replicate the assets underlying the benefit.

*An embedded derivative approach*

27. An embedded derivative approach aims to resolve the first concern noted above, and to provide a simpler, more intuitive answer for asset based benefits. Put simply, it would require that in any post-employment plan, specified embedded derivatives would be stripped out of the plan and measured at fair value. The specification could either be of those derivatives that should be stripped out or those that should be left in the host plan. The staff's initial view is that we would specify those derivatives that should be left in the host plan. The host plan after the appropriate derivatives had been removed would be accounted for as a DB or DC plan in accordance with the existing definitions and requirements in IAS 19. We think that by doing this, asset based benefits would fall either into a host DC plan or an embedded derivative.

28. The staff is aware that the requirement in IAS 39 to strip out embedded derivatives from host contracts has caused problems. We think we can avoid such problems by a careful definition of what embedded derivatives should remain in the host plan and which should be stripped out. However, further problems arise because:

- (a) the host plan that is left is sometimes a combination of DB and DC components (which makes it DB under IAS 19) and
- (b) if we leave the DC definition as it is under IAS 19, 'unfunded DC' benefits would be treated under this approach as an embedded derivative rather than as a DC host plan. This does not affect the measurement of the liability for the benefits, but it does affect the way the pension cost is split into components.

29. All these issues will be brought back to Board in more detail in January.

*A deconstruction approach*

30. A deconstruction approach aims to resolve some of the issues identified in the embedded derivative approach. This approach acknowledges that the current definitions of, and measurement methodology for, DB and DC plans are useful only for typical DB and typical DC arrangements. It splits all plans into:
- (i) a salary based or fixed benefit
  - (ii) an asset based benefit and
  - (iii) an optional derivative benefit.
31. In doing this, it replaces the existing definitions of DB and DC in IAS 19. But the replacement definitions of a DB component (ie salary based or fixed benefits) and the DC component (ie asset based benefits) mean that the current accounting for typical final salary plans and 'pure' DC plans would remain unchanged.
32. The salary based and fixed benefits would be accounted for using the existing IAS 19 defined benefit methodology. The asset based benefits would be measured at the fair value of the underlying assets. The optional derivative component would capture any optionality between different benefits and would be measured at fair value.
33. Again, the staff will bring details of this approach to the January meeting.