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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:** 17 April 2007, London

**Project:** IAS 19 Post-employment benefits

**Subject:** Cash balance and similar plans  
Treatment of inflationary increases  
(Agenda paper 4B)

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### **Introduction**

1. In Paper 4A, the staff proposed that benefit promises with fixed increases should be treated as defined benefit.
2. As part of Phase I, the staff recommends that the Board also clarifies the accounting treatment of inflation-linked benefits. In principle, these benefit promises are asset-based as their amounts change in response to the change in an index (such as the retail prices index or its equivalent).
3. However, the staff thinks that there are convincing reasons for treating wage and price inflation-linked benefits as defined benefit promises. The main arguments in favour of such an approach are discussed below.

## **Staff Recommendation**

4. The staff recommends that benefit promises that are linked to price and wage inflation are treated as defined benefit, whether or not they include an embedded derivative component because:
  - (i) Treating such inflation-linked benefit promises as asset-based would result in a significant change in the accounting for many final salary benefit promises and give rise to anomalous gains and losses on retirement.
  - (ii) The application of the current IAS 19 measurement requirements for defined benefit plans to inflation-linked benefit promises raises very similar issues to those relating to salary-based benefits. In particular, constituents have not raised problems in measuring inflation-linked benefit promises using the projected unit credit method in IAS 19. The Board decided that the issues arising for these benefit promises were of a lower priority than the other issues being considered in Phase I of the project.
  - (iii) Treating any caps or floors on inflation-linked benefits as asset-based adds considerably to the complexity of the definitions in Phase I. This would make the proposed changes more difficult for constituents to understand and implement.
5. Finally, the staff recommends that other types of inflation-linked benefits, excluding price and wage inflation (eg benefit promises linked to property price inflation) are treated as asset-based.
6. Therefore the staff would propose the following revision to the definition of asset-based promises, the other proposed definitions would be left unchanged:

An asset-based benefit promise is one whose amount changes in response to the change in an asset or index, other than assets or indices that are linked to price or wage inflation or that yield fixed increases.

## **Inflation-linked benefits as asset-based benefits**

7. Many final salary benefit promises are pension payments that increase with price inflation. If inflation-linked pensions in payment were treated as asset-based, this would result in a significant change in the accounting for many final salary benefit promises.
8. This is similar to the difficulty encountered in respect of treating benefit promises with fixed increases as asset-based. Such an approach would significantly alter the accounting requirements for final salary benefit promises, which typically include inflation-linked promises for all retirees and deferred members.
9. Consider the following plan (similar to Plan E in Paper 4A):

The employee's post-employment benefit entitlement is equal to annual pension payments of 2% of final salary for each year of service, payable for life. The annual pension payments increase in line with the increase in the retail prices index.

10. In this case, if inflation-linked benefits are classified as asset-based, the liability in respect of deferred and retired members would be required to be measured at fair value, while the liability for other members (ie active employees) in the same plan would be measured using the PUC method.
11. As explained in Paper 4A, such an approach would also give rise to anomalous gains and losses on retirement. It would also require a significant change in internal valuation procedures and is likely to be very costly, time-consuming and complex. Further, the Board decided not to change the accounting requirements for typical final salary benefit promises. Treating inflation-linked benefit promises as asset-based would therefore represent a significant expansion of the scope.

## **Application of current IAS 19 measurement requirements**

12. The application of current IAS 19 measurement requirements to typical final salary and most inflation-linked benefits has been unproblematic (see paragraphs 15 – 21 for exceptions). The PUC methodology requires projection of expected benefit payments and the use of the AA corporate bond yield as a proxy for the nominal risk free yield.

13. The Board accepted retaining the current IAS 19 measurement requirements for typical final salary benefit promises. In particular, the Board decided that the issues arising in respect of these and similar benefit promises were of a lower priority than the other issues being considered in Phase I of the project.
14. The staff notes that any issues relating to the appropriateness of IAS 19 measurement requirements for inflation-linked benefits will be similar to those relating to salary-linked benefits. Therefore, if typical final salary benefit promises are not considered in Phase I, the staff recommends that the issues relating to inflation-linked benefits should also not be dealt with in Phase I of the project.

### **Inflation –linked benefits with embedded derivatives**

15. There are some types of inflationary increases for which the application of the projected unit credit method could be argued to be inappropriate. For example, LPI increases in the UK guarantee inflationary increases at the lesser of 5% and the increase in the Retail Prices Index.
16. The application of the projected unit credit method to this type of benefit promise would ignore the value of the 5% cap and would not give a faithful representation of the liability which the entity holds.
17. However, many constituents claim that, in practice, when valuing these types of benefits, an adjustment is made to the inflation assumption to allow for the embedded derivative which gives an answer that is almost as good as valuing the benefit using a more appropriate methodology.
18. Further, the Board tentatively decided previously that the measurement of optionality in defined benefit promises would not be changed in Phase I of the project. For instance, a benefit promise could be the higher of final salary or the average of the last five years' salary before retirement. However, since the the accounting for final salary and similar plans would be dealt with in Phase II, the Board tentatively concluded that any optionality related to final salary and similar promises only should also be dealt with in Phase II.
19. The staff notes that a conceptually better approach would be to treat the embedded derivative component of inflation-linked benefits as asset-based.

However, this would add a considerable amount of complexity to the definition of asset-based benefits. The definition would become: *a benefit promise whose amount changes in response to the change in an asset or index, other than assets or indices that yield fixed increases or that are linked to price or wage inflation and do not include an embedded derivative*. It would also add to the complexity and costs of the valuation of these types of benefits.

20. The staff thinks that introducing such complexity in advance of a comprehensive review of the accounting for employee benefits would be counterproductive and make the proposed changes more difficult for constituents to understand and implement.
21. Therefore the staff recommends that, for Phase I, inflation-linked benefit promises are treated as defined benefit and measured using the PUC method, whether or not they include an embedded derivative component.

### **Other types of inflation-linked benefits**

22. There are many types of inflation-linked indices. Benefits may be linked to a price index, earnings index, property inflation index or other types of notional or actual asset-based indices.
23. The staff argues that price and wage inflation-linked promises should be categorised as defined benefit because they are similar to salary-linked benefits. In particular, the application of the current IAS 19 measurement requirements to these types of benefit promises raises very similar issues to those relating to salary-based benefits.
24. However, it is not clear that the application of the current IAS 19 measurement requirements to benefit promises linked to other types of indices should also be categorised as defined benefit. These benefit promises may not raise similar issues to those relating to salary-based benefits. In particular, the application of the PUC method to these types of benefits may be troublesome.
25. The staff recommends, therefore, that only price and wage inflation-linked benefits are treated as defined benefit and all other types of inflation-linked benefits are treated as asset-based.