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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 benefits with fixed increases
(Agenda paper 4A)

Introduction

1. At the previous meeting, the staff proposed three new definitions for post-employment benefits:
 - (i) A defined contribution benefit promise is one for which the entity has no further obligation in respect of current and prior periods once the defined contributions have been paid into a separate fund. These benefit promises are accounted for in accordance with current IAS 19 requirements for defined contribution plans.
 - (ii) 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 yield fixed increases. These benefit promises are measured at fair value.
 - (iii) All other benefit promises are defined benefit. Typically, defined benefit promises change in line with specified fixed increases, service or salary.

These benefit promises are measured in accordance with current IAS 19 requirements for defined benefit plans.

2. Some Board members thought that benefits with fixed increases should be treated as asset-based rather than as defined benefit. This paper addresses the implications of such an approach.

Staff recommendation

3. The staff notes that treating fixed increases as asset-based has the following implications:
 - (i) A line would have to be drawn between (i) current salary benefits and some average salary benefits and (ii) final salary benefits and other average salary benefits;
 - (ii) For some benefits (eg typical final salary benefits) anomalous gains or losses will arise on retirement; and
 - (iii) There would be a significant change in the accounting for some aspects of typical final salary benefits.
4. The classification of benefit promises with fixed increases as defined benefit avoids the difficulties outlined above. It is also a pragmatic approach since constituents have not raised problems in measuring benefit promises with fixed increases using the projected unit credit method in IAS 19. Therefore the staff recommends that benefit promises with fixed increases are categorised as defined benefit.
5. A summary of the example plans used in the paper is set out in the appendix.

Fixed benefits and fixed increases as asset-based benefits

6. At the previous meeting, the Board noted that benefit promises with fixed increases meet the definition of asset-based benefits and tentatively decided that these benefit promises should be treated as asset-based on the grounds that this is a simpler and conceptually more robust approach.
7. The staff wishes to raise with the Board some implications of this decision.

Fixed benefits and fixed increases and the classification of benefit promises

8. The following three example plans illustrate the implications of treating fixed benefit promises as asset-based benefits on the classification of other benefits. The staff argues that fixed benefits and fixed increases should be classified as defined benefit in order to avoid drawing a line between (i) current salary benefits and some average salary benefits and (ii) final salary benefits and other average salary benefits.
9. Consider the following four plans:
 - Plan A:** The employee is entitled to a lump sum benefit equal to 3% of his current salary in each year of service for the 20 years before retirement. (ie 3% accrual with no increases – or fixed increases of 0%).
 - Plan B:** The employee is entitled to a lump sum benefit equal to 3% of the career average of the employee's salary, with no revaluation, for each year in the last 20 years of service before retirement.
 - Plan C:** The employee is entitled to a lump sum benefit equal to 3% of the final 20 year average of salary for each year of the last 20 years of service before retirement.
 - Plan D:** The employee is entitled to a lump sum benefit equal to 3% of final salary for each year of the last 20 years of service before retirement.
10. Plan A and Plan B provide the same benefit promise, whenever an employee leaves service, although the promise is described differently. The way in which a benefit is described should not affect how it is accounted for. Therefore, if the benefit in Plan A is classified as asset-based, the same benefit in Plan B must also be asset-based.
11. Plan C provides the same benefit promise as plans A and B and, by a similar reasoning, should also be treated as asset-based. In this case, the benefit promise is described as a final average salary plan with an averaging period of 20 years.

12. The first three plans provide the same benefit and should therefore be treated the same. Plan D does not provide the same benefit promise as plan C. However, the staff argues that Plan D should also be treated the same as Plan C, because treating the two plans differently would lead to counterintuitive results, as explained below.
13. Plan C is a final average salary plan with an averaging period of 20 years. If the salary averaging period is reduced to 19, 18 or 17 years, this should not change the categorisation of the benefit promise, as only the amount of the risk has changed, not the nature of the risk to which the entity is exposed. So, a final average salary plan with an averaging period of 20 years should be categorised the same as other final average salary plans, including a final average salary plan with an averaging period of just one year.
14. However, a final average salary plan with an averaging period of one year is simply a final salary plan (Plan D). It follows, therefore that plan D should be treated the same as plan C.
15. One possible counter-argument to this approach is that it is possible to identify a non-arbitrary dividing line between (i) current salary benefits and (ii) final salary and other average salary benefits. In general terms, such an approach would treat benefits that were based on an average of salary over the whole period of service as current salary benefits which could be distinguished from benefits that were based on an average of salary over a period, other than the whole period of service.
16. In other words, benefits that can be described in current salary terms (with no additional salary based revaluations) would be asset-based and benefits that cannot be so described would be defined benefit. That would put the line in the above examples between Plan C and all final average salary plans with an averaging period of less than 20 years.
17. For example consider two new plans C1, and D1 which provide the following benefit promise:

Plan C1: The employee is entitled to a lump sum benefit equal to 3% of the final 20 year average of revalued salary for each year of the last 20 years of service before retirement, with revaluation at 2%, for each year in the last 20 years of service before retirement

Plan D1: The employee is entitled to a lump sum benefit equal to 3% of the final 10 year average of revalued salary, for each year of the last 20 years of service before retirement. Revaluation is at 2% for each year in the last 10 years of service before retirement

18. Plan C1 could be described in terms of current salary with non-salary based revaluation, ie *The employee is entitled to a lump sum benefit equal to 3% of his current salary in each year of service for the 20 years before retirement. The annual accrual of 3% of current salary is increased at the rate of 2% per year. (ie 3% accrual with fixed increases of 2% per year – no salary-based revaluation).*
19. Plan D1 cannot be described in current salary terms without including a salary-based revaluation. Eg Plan D1 could be expressed as *The employee is entitled to a lump sum benefit equal to 3% of his current salary in each year of service for the 20 years before retirement. The annual accrual of 3% is increased at the rate of 2% times the ratio of the 10 year average revalued salary to the current year's salary – salary-based revaluation).*
20. Therefore Plan C1 would be asset-based but plan D1 would be defined benefit since it cannot be expressed in current salary terms without a salary-based revaluation.
21. If this approach is followed, many career average plans would be treated as asset-based. However, career-average salary benefits of the type in Plan C and C1 are treated by SFAS 87 and IAS 19 as similar to final-salary benefits. The staff thinks it would be difficult to justify to constituents why we would draw a line in the middle of average salary benefits, linking some with final salary benefits and others with current salary benefits. It would also be seen as a significant change to the accounting of benefits to which the application of SFAS 87 and IAS 19 have been regarded as relatively straight-forward.
22. Therefore, the staff argues that all six plans (including those such as Plan A with fixed increases) should receive the same accounting treatment - as defined benefit promises. This would mean that all fixed increases should be treated as defined benefit.

Fixed benefits and fixed increases: anomalous gains and losses

23. The second argument against treating fixed increases as asset-based is that for some benefit promises, the approach results in anomalous gains or losses on retirement or leaving service. This is explained further below.
24. Consider the following plan:
- Plan E:** 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.
25. For an employee in service, the benefit would be linked to service and salary and so would be defined benefit. However, once the employee retires or leaves service, the benefit would simply be a promise to pay a fixed amount, based on the now known final salary and service period, over the remainder of the retiree's life. This is equivalent to a benefit promise with fixed increases equal to 0% and so would be asset-based. In other words, the classification of the benefit changes from defined benefit whilst the employee is in service to asset-based once the employee retires or leaves service.
26. As a result, the present value of the defined benefit obligation would be measured using the PUC method before retirement or leaving service and the fair value method after retirement or leaving service. The fair value of the benefit promise could be significantly different from the PUC value of that benefit promise. Therefore the change of the classification of the pension promise on retirement could result in a significant gain or loss.
27. It is arguable that since an event has occurred, ie retirement or leaving service, that a gain or loss should be expected. However, the gain or loss on retirement which would arise would not be commensurate with the change in the risk, as explained below.
28. On retirement, the salary and service risks reduce to zero. However, the salary and service risk to the entity the day before the employee retires are minimal, therefore the effect of retiring should be very small. The gain or loss which arises under this approach is more likely to be representative of the discrepancy between the fair value and PUC methods, than the change in risk.

Fixed benefits and fixed increases: changes in accounting for final salary plans

29. The third argument against treating fixed increases as asset-based is that such an approach would result in a significant change in the accounting for some aspects of final salary plans.
30. In particular, as noted above, it would significantly alter the accounting requirements for typical final salary plans for all retirees and deferred members (ie all members in the pay-out phase). 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.
31. Such an approach would 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 final salary plans. This approach would therefore represent a significant expansion of the scope.
32. Overall, therefore, the staff argues that an approach that classifies all benefits with fixed increases as defined benefit is preferable to one which categorises them as asset-based. In this case:
- (i) No counter-intuitive results would arise for plans for which the nature of the benefit promise is the same - all career average plans would be treated the same as final salary;
 - (ii) No anomalous gains or losses will arise on retirement for final salary plans; and
 - (iii) There would be no change in the accounting for any aspects of typical final salary plans.
33. Such an approach would still allow the Board to significantly improve the accounting for the range of plans for which constituents have found the current accounting requirements troublesome (ie asset-based plans).

[Paragraphs 34 -37 omitted from the Observer Notes]

Example Plans

- Plan A:** The employee is entitled to a lump sum benefit equal to 3% of his current salary in each year of service for the 20 years before retirement. (ie 3% accrual with no increases – or fixed increases of 0%).
- Plan B:** The employee is entitled to a lump sum benefit equal to 3% of the career average of the employee's salary, with no revaluation, for each year in the last 20 years of service before retirement.
- Plan C:** The employee is entitled to a lump sum benefit equal to 3% of the final 20 year average of salary for each year of the last 20 years of service before retirement.
- Plan C1:** The employee is entitled to a lump sum benefit equal to 3% of the final 20 year average of revalued salary for each year of the last 20 years of service before retirement, with revaluation at 2%, for each year in the last 20 years of service before retirement
- Plan D:** The employee is entitled to a lump sum benefit equal to 3% of final salary for each year of the last 20 years of service before retirement.
- Plan D1:** The employee is entitled to a lump sum benefit equal to 3% of the final 10 year average of revalued salary, for each year of the last 20 years of service before retirement. Revaluation is at 2% for each year in the last 10 years of service before retirement
- Plan E:** 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.