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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **22 February 2007, London**

Project: **IAS 19 – Post-employment Benefits**
Cash balance and similar plans

Subject: **Definitions of Benefit Promises (Agenda paper 8A)**

Introduction

1. IAS 19 *Employee Benefits* includes within its scope all forms of benefit promises made by an entity in exchange for service rendered by employees.[1] This includes defined contribution and defined benefit plans. An example of a defined contribution plan is one where the entity is required to pay contributions to the plan and there is no further obligation once the contributions have been paid. An example of a defined benefit plan is one where the entity promises a pension equal to a fixed percentage of salary for each year of service.

2. In the shift away from typical defined benefit arrangements, a number of entities have opted to provide benefit promises that were not considered when IAS 19 (and its US GAAP counterpart SFAS 87) were written. In addition, jurisdictional requirements have also given rise to a number of plans that were not fully contemplated in the writing of IAS 19. This has created difficulties in

[1] Other than share-based payments.

practice in applying the prescribed accounting measurement method to some defined benefit plans such as cash balance plans.

3. At the December meeting, the Board held a preliminary discussion of the accounting for cash balance and similar plans. The Board noted that the troublesome plans are largely those that offer asset-based benefits and asked the staff to propose revised definitions to distinguish clearly between defined benefit and defined contribution plans and identify asset-based benefits separately from salary-based benefits.

4. This paper identifies some of the measurement difficulties that arise on the application of IAS 19 requirements to some plans. The paper also sets out tentative suggestions for definitions of three categories of benefit promises: defined contribution, defined benefit and asset-based.

5. Paper 8B paper provides a more detailed consideration of the recommended measurement approach for cash balance and similar plans.

6. The staff notes that these are preliminary views only. The Employee Benefits Working Group, which is currently being composed, will provide input on these proposals in due course.

Examples of benefit promises

7. The staff analysis uses the following seven examples of typical present-day benefit promises. In accordance with common usage, the term benefit promise is used to refer to all forms of post-employment benefits. In particular a defined contribution plan is categorised as a type of benefit promise, even though, in this case, there is no obligation to the entity. A summary of the examples is also set out in the appendix.

   Plan A: An annual pension income benefit equal to 5% of final salary for each year of service.

   Plan B: A lump sum benefit accumulated as follows: The entity pays contributions of 8% of salary for each year of service and the return on contributions is equal to the actual return on plan assets. The entity has no further obligation to pay further contributions to the plan, once the defined contributions are paid.

Plan C – A lump sum benefit accumulated as follows: The entity pays contributions of 8% of salary for each year of service and the return on contributions is fixed at a rate of 4% per year until retirement.

Plan D: A lump sum benefit accumulated as follows: The entity pays contributions of 8% of salary for each year of service and the return on contributions is the actual return on plan assets with a guaranteed minimum return per year of 3.25%.

Plan E – A lump sum benefit accumulated as follows: The entity pays contributions of 8% of salary for each year of service and the return on contributions is in line with the change in an equity index.

Plan F – A benefit equal to the higher of:

- A lump sum benefit accumulated as follows: the entity pays contributions of 8% of salary for each year of service and the return on contributions is equal to the actual return on plan assets; and
- a lump sum benefit equal to 5% of final salary for each year of service.

Plan G – A benefit equal to:

- For the first 15 years of service, a lump sum benefit accumulated as follows: the entity pays contributions of 8% of salary for each year of service and the return on contributions is equal to the actual return on plan assets.
- For the next 15 years' service, a pension of 3% of salary per year.
- With an overall minimum guarantee, after 15 years' service, of a pension income of 2% of final salary per year of service, assuming the lump sum is converted to a pension at market annuity rates.

Plans for which the measurement method should not change

8. The first three examples of benefit promises in Plans A, B and C are plans that the staff understands were envisaged when SFAS 87 and IAS 19 were developed. Any changes in respect of the measurement of these types of plans will be dealt with in Phase II of the Employee Benefits project.

Plan A: An annual pension income benefit equal to 5% of final salary for each year of service.

9. For plan A, the IAS 19 methodology requires the use of the Projected Unit Credit (PUC) method with a discount rate equal to the yield on AA corporate bonds. The PUC requires the amount of the benefits payable at retirement, based on accrued service and estimated final salary, to be projected to retirement date and discounted to the balance sheet date. An allowance is made for future salary increases and for demographic changes in the period to retirement.

This type of benefit was envisaged when IAS 19 was developed. The staff recommends that there should be no change to the accounting methodology for this type of plan.

Plan B: A lump sum benefit accumulated as follows: The entity pays contributions of 8% of salary for each year of service and the return on contributions is equal to the actual return on plan assets. The entity has no further obligation to pay further contributions to the plan, once the defined contributions are paid.

10. The entity has no obligation in respect of plan B, once the contributions are paid. IAS 19 requires the entity to recognise the contributions paid as an expense. A liability/asset would be recognised only to the extent that the contributions payable are greater/less than the contributions paid.

As this type of benefit was envisaged when IAS 19 was developed, the staff recommends that there should be no change to the measurement for this type of plan.

Plan C: A lump sum benefit accumulated as follows: The entity pays contributions of 8% of salary for each year of service and the return on contributions is fixed at a rate of 4% per year until retirement.

11. IAS 19 requires the liability in plan C to be measured using the PUC method. Therefore the expected amount of the retirement benefit payable will be projected based on the contributions increased at 4% per year. This projected amount would then be discounted using the yield on AA corporate bonds.

The staff acknowledges that plan C could be argued to provide an asset-based benefit because the benefit promise could be described as relying on assets that yield a fixed return eg fixed coupon bonds. Nonetheless, the staff thinks this type of plan was envisaged when IAS 19 was developed. The staff therefore recommends that there should be no change to the accounting methodology for this type of plan.

Plans for which the measurement method should change

12. The next 4 examples of benefit promises are those that the staff argues were not envisaged when SFAS 87 and IAS 19 were developed.

Plan D: A lump sum benefit accumulated as follows: the entity pays contributions of 8% of salary for each year of service and the return on contributions is the actual return on plan assets with a guaranteed minimum return per year of 3.25%.

13. IAS 19 would require the liability in plan D to be measured using the PUC method. Therefore the expected amount of the retirement benefit payable will be projected based on the expected return on plan assets. This projected amount would then be discounted using the yield on AA corporate bonds.

14. This approach gives rise to anomalous results in some cases. The examples below show that IAS 19 would give the same measure of the entity's obligation for plans with different benefit promises. In particular, the entity clearly has a bigger obligation in plan D2, but this is not reflected in the measure of the obligation when compared with plan D1. This is because the PUC method ignores the value of the guaranteed minimum return.

	Plan D1 ***a guaranteed minimum return of 3.25%***	***Plan D2*** ***a guaranteed minimum return of 3.75%***
Minimum rate of return	*3.25%*	*3.25%* ***+ 0.5%***
Discount rate	*4.00%*	*4.00%*

Expected rate of return	*4.00%*	*4.00%*
Present Value of the Defined Benefit Obligation	*100*	*100*

The staff recommends that the measurement of the entity's obligation includes the value of any minimum or maximum guarantees in the benefit promise. More details in respect of the proposed approach are set out in paper B.

Plan E: A lump sum benefit accumulated as follows: the entity pays contributions of 8% of salary for each year of service and the return on contributions is in line with the change in an equity index.

15. IAS 19 would require the liability in plan E to be measured using the PUC method. In this case, the expected amount of the retirement benefit payable will be projected based on the contributions increased in line with the expected return on the index. The expected retirement benefit is then discounted at the yield on AA corporate bonds.

16. The staff has observed that it is often the case that the assumption used for the expected return on assets is higher than the AA corporate bond yield. This means that, in these cases, the entity's obligation would be measured at a value higher than the market value of the assets upon which the liability is based and with which the liability could be settled.

The staff recommends that an alternative measurement method is used for plans which provide benefit promises that, like plan E, are asset-based. More details in respect of the proposed approach are set out in paper B.

Plan F:

A benefit equal to the higher of:

- A lump sum benefit accumulated as follows: the entity pays contributions of 8% of salary for each year of service and the return on contributions is equal to the actual return on plan assets; and
- a lump sum benefit equal to 5% of final salary for each year of service.

17. IAS 19 would require the measurement of the liability in plan F using the PUC method. Therefore the expected amount of the retirement benefit payable will be calculated by projecting both types of benefits to retirement and determining which provides the higher expected amount. This projected amount would then be discounted using the yield on AA corporate bonds.

18. The value of the guarantee to receive the higher of the two benefits is ignored. Therefore the entity's obligation could be significantly underestimated. Also as noted for Plan E, the application of the PUC method for the part of the benefit that is asset-based produces anomalous results.

The staff recommends that an alternative measurement method is used for plans which provide benefit promises that include guarantees and/or asset-based benefits. More details in respect of the proposed approach are set out in paper B.

Plan G: A benefit equal to:

- For the first 15 years of service, a lump sum benefit accumulated as follows: the entity pays contributions of 8% of salary for each year of service and the return on contributions is equal to the actual return on plan assets.
- For the next 15 years' service, a pension of 3% of salary per year.
- An overall minimum guaranteed pension income benefit of 2% of final salary per year of service, after 15 years' service, assuming the lump sum above is converted to a pension at market annuity rates.

19. IAS 19 would require the measurement of the liability in plan G using the PUC method. Therefore the expected amount of the retirement benefit payable will be calculated by projecting the benefits to retirement and determining which provides the higher expected value, based on the contributions, the expected return on plan assets and expected salary increases. This projected amount would then be discounted using the yield on AA corporate bonds.

20. Again, the PUC ignores the value of the maximum guarantee to receive the higher of the two benefits. The staff's previous recommendation that the measurement of the entity's obligation includes the value of the guarantee would also apply in this case.

21. In addition, the staff notes that IAS 19 would look at a plan in its entirety and categorise it as DB or DC as a whole. However, this plan consists of three separate types of benefit promises: the first portion is DC, the second portion DB and the final portion is an asset-based guarantee. Therefore both the defined contribution benefit promise and the asset-based guarantee would be measured using the PUC method. As noted above this leads to anomalous results.

22. The approach the staff proposes in Paper B requires the identification of the different types of benefit promises in the plan, so that they could be measured appropriately independently and then aggregated in order to determine the accounting for the plan as a whole. More details in respect of this are set out in Paper B.

The staff recommends that a new approach is required for plans with two or more benefit promises. More details in respect of this proposed approach are set out in paper B.

Revised definitions for existing categories of benefit promises

23. Plans A – C above illustrate the types of benefit promises that the staff thinks should continue to be accounted for under the current IAS 19 requirements. As directed by the Board, the staff has attempted to revise the definitions of defined benefit and defined contribution benefit promises in order to clarify the categories of benefit promises.

- Defined Contribution benefit promises

24. Plan B is a typical example of a defined contribution plan using IAS 19 definition criteria. The defined contribution methodology was developed for plans in which the entity's only obligation is to pay a certain level of contributions into the plans and under which the entity has no further risk in respect of the ultimate benefit promise payable from the plan. The current IAS 19 definition attempts to capture this notion as follows:

> 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 current and prior periods.

25. At the last meeting, some Board members noted that the notion of sufficiency of assets is irrelevant for a defined contribution plan. The staff agrees. By definition, the assets in a DC plan must be sufficient to pay the benefit promise in respect of current and prior periods, as the entity's only obligation is to make the contribution payments set out in the benefit promise.

The staff recommends the following revised definition to avoid this circularity: 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.

- Defined Benefit promises

26. Plans A and C are examples of plans which would meet the current definition of a defined benefit promise. Under IAS 19, defined benefit plans are all the plans which are not defined contribution.

27. The staff thinks that the group of plans that are not defined contribution can be separated into two categories: those envisaged when SFAS 87 and IAS 19 were being developed and for which the PUC method was regarded as appropriate, and those which were not envisaged at that time.

28. The former group comprises those where the promise relates to salary and service (Plan A) or those related to fixed increases (Plan C). The staff proposes that the term *defined benefit* is restricted to these types of benefit promises.

29. The staff notes that fixed increases could be argued to be asset-based rather than defined benefit because they could be described as relying on assets that yield a fixed return eg fixed coupon bonds. The staff agrees but notes that the scope of the project is limited to those plans that were not envisaged when IAS 19 was written and for which the application of the PUC method proves troublesome. Benefit promises with fixed increases do no meet either of these

criteria. Further, changing the measurement of benefit promises with fixed increases would widen the scope of the project considerably.

As a starting point, therefore, the staff proposes the defined benefit promise is defined as one whose amount changes in line with specified fixed increases, service or salary. This definition is developed further later.

New definitions for new categories of benefit promises

30. Plans D – G illustrate types of benefit promises for which the current accounting methodology was not developed and the accounting for which the staff thinks should be reconsidered. These include benefit promises that are linked to indices (Plan E), or have minimum or maximum guarantees linked to assets or indices (Plans D – G).

31. The Board had referred to these types of benefit promises as asset-based. The staff notes that, arguably, indices and guarantees are not assets as such, but are linked to assets (in the same way that a derivative relies on the change in the value of underlying assets). The staff preferred to avoid using the term derivative as the meaning of the term in IAS 39 could imply a number of other types of features, which the staff does not wish to address in this Phase of the project,. Therefore the staff has continued using the term asset-based for this category of benefit promises.

As a starting point only, the staff proposes the asset-based benefit promise is defined as a benefit promise, the amount of which changes in response to the change in an asset or index. This definition is revised further below.

32. The proposed definition of asset-based benefits automatically includes optionality or guarantees linked to assets or indices (eg plans D and E) but it excludes benefit promises that include optionality between two defined benefit promises. This would mean that optionality between two salary-related components or between a fixed increase and a salary-related component, for instance, would be ignored.

33. These treatments of optionality may appear to be inconsistent. However, the staff thinks that optionality between defined benefit promises (as newly defined) should be excluded from the scope of the project. The key reason for this is that the accounting for salary-related benefits is outside the scope of this

project. Including optionality between salary-related components would involve significant scope creep and raise further questions in respect of the treatment of salary increases which the Board decided would not be dealt with in Phase I.

Other benefit promises

34. The staff notes that there is a residual collection of benefit promises which have not yet been explicitly considered ie those that do not rely only on service or salary, fixed increases, indices or plan assets. One example of this would be plans which are not defined contribution but which provide a benefit, the level of which depends on performance hurdles. The proposed definitions of defined benefit and asset-based benefits above exclude these 'residual' benefits.

35. The benefit category into which these benefit promises should fall depends on the measurement methodology that is deemed appropriate for them.

36. One view (Alternative 1) is that we should only require the PUC method for those benefit promises which were envisaged when IAS 19 was developed. All other benefit promises should be subject to the new measurement approach, which should be better able to cope with unusual or complicated benefit structures than the PUC method. The staff does not think that benefits that depend on conditions other than service, salary or fixed increases were fully contemplated when IAS 19 was developed. Also, placing the residual benefit promises in the asset-based category reduces the risk of accounting arbitrage. This could occur if plans are described so as to not appear to be asset or index-linked in order to avoid the requirement to use the new measurement method. Finally, if residual benefit promises are included in the defined benefit category, there is a risk that significant optional guarantees would be ignored using the PUC method.

37. Another view (Alternative 2) is that the scope of Phase I is limited to the work that can be done in a four year period and any changes should be limited to the 'troublesome' plans that are clearly identified. This avoids the possibility of inadvertently changing the measurement requirements for plans of which the staff is unaware. Further, the optionality between defined benefit components (including 'residual' benefit promises) has always been ignored and it is not

within the scope of Phase I to address the accounting for these types of benefit promises.

38. The definition of the defined contribution benefit promise is the same under both alternatives. However, the proposed definitions for defined benefit and asset-based benefit promises would be different as illustrated below.

Post Employment benefits are employee benefits (other than termination benefits) which are payable after the completion of employment. These benefits are comprised of *defined contribution, defined benefit* and *asset-based* promises. [Similar modifications would be required for other long-term and termination benefits].

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.

Alternative 1 (residual benefits in asset-based category)

A defined benefit promise is one whose amount changes in line with specified fixed increases, service or salary.

All other benefit promises[2] are asset-based benefit promises. Typically, asset-based benefit promises change in response to the change in an underlying variable such as an asset or an index.

Alternative 2 (residual benefits in defined benefit category)

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 .

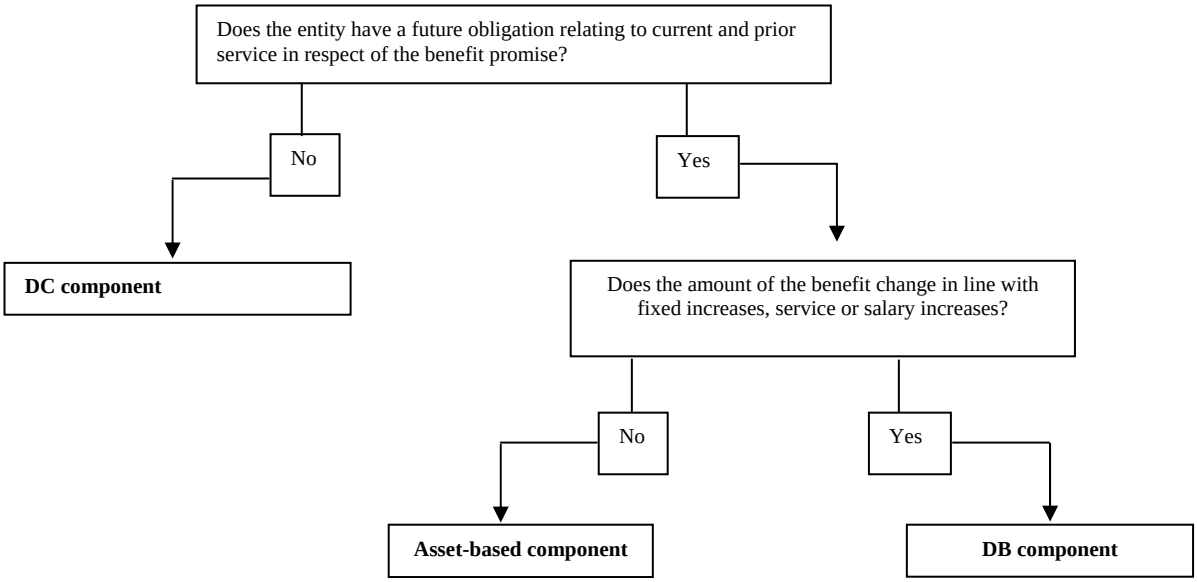
All other benefit promises[3] are defined benefit. Typically, defined benefit promises change in line with specified fixed increases, service or salary.

[2] Ie benefit promises that are not defined contribution or defined benefit (as newly defined).

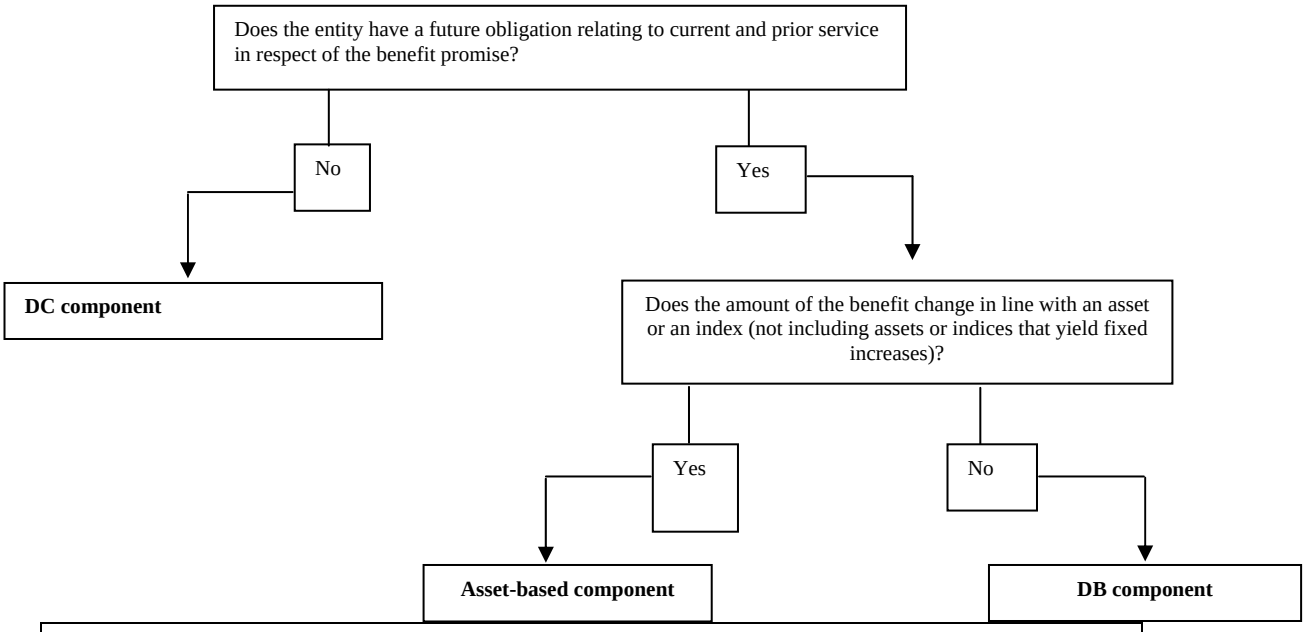
[3] Ie benefit promises that are not defined contribution or defined benefit (as newly defined).

39. Further details in respect of the identification and measurement of the different types of benefit promises are set out in paper B. The flowcharts below show how to distinguish the different types of benefit promises using the three proposed definitions under the two alternatives.

Alternative 1



Alternative 2



The staff recommends Alternative 2 which categorises the residual benefit promises as defined benefit for the reasons set out above.

Summary of staff recommendations

40. The staff recommends the identification of three categories of benefit promises:

Post Employment benefits are employee benefits (other than termination benefits) which are payable after the completion of employment. These benefits are comprised of *defined contribution, defined benefit* and *asset-based* promises. [Similar modifications would be required for other long-term and termination benefits].

41. **The tentative definitions put forward in respect of the three benefit promises are as follows**

(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.

(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 using a new measurement approach as set out in Paper B.

(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 to be measured in accordance with current IAS 19 requirements for defined benefit plans.

APPENDIX

Example Plans

Plan A: An annual pension income benefit equal to 5% of final salary for each year of service.

Plan B: A lump sum benefit accumulated as follows: The entity pays contributions of 8% of salary for each year of service and the return on contributions is equal to the actual return on plan assets. The entity has no further obligation to pay further contributions to the plan, once the defined contributions are paid.

Plan C – A lump sum benefit accumulated as follows: The entity pays contributions of 8% of salary for each year of service and the return on contributions is fixed at a rate of 4% per year until retirement.

Plan D: A lump sum benefit accumulated as follows: the entity pays contributions of 8% of salary for each year of service and the return on contributions is the actual return on plan assets with a guaranteed minimum return per year of 3.25%.

Plan E – A lump sum benefit accumulated as follows: the entity pays contributions of 8% of salary for each year of service and the return on contributions is in line with the change in an equity index.

Plan F – A benefit equal to the higher of:

- A lump sum benefit accumulated as follows: the entity pays contributions of 8% of salary for each year of service and the return on contributions is equal to the actual return on plan assets; and
- a lump sum benefit equal to 5% of final salary for each year of service.

Plan G – A benefit equal to:

- For the first 15 years of service, a lump sum benefit accumulated as follows: the entity pays contributions of 8% of salary for each year of service and the return on contributions is equal to the actual return on plan assets.
- For the next 15 years' service, a pension of 3% of salary per year.

With an overall minimum guarantee, after 15 years' service, of a pension income of 2% of final salary per year of service, assuming the lump sum is converted to a pension at market annuity rates.