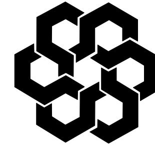

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This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on 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:	**22 February 2007, London**
Project:	**IAS 19 – Post-employment Benefits** **Cash balance and similar plans**
Subject:	**Introduction to measurement approach (Agenda paper 8B)**

Introduction

1. As part of Phase I of the Employee Benefits project, the Board decided to address the accounting for cash balance and similar types of plans.

2. In Paper A, the staff discussed some of the measurement difficulties that arise as a result of the application of IAS 19 to some plans, and proposed definitions of three types of benefit promises: defined benefit, defined contribution and asset-based.

3. This paper discusses further details of the measurement approach proposed by the staff. The staff analysis is based on the same seven examples of typical benefit promises used in Paper A. All 7 examples are set out in Appendix A.

Summary of staff recommendations

4. **The staff recommends the separation of the plan into defined benefit, defined contribution and asset-based promises, where applicable. The**

benefit promises would be measured independently and then aggregated in order to determine the accounting for the plan as a whole.

5. **Defined benefit and defined contribution plans will continue to be accounted for in accordance with the current IAS 19 requirements. Asset-based benefit promises will be measured at fair value.**

6. **The hierarchy of identification of the benefit promises is: DB benefit promises, then asset-based or defined contribution promises.**

7. **An entity would not be allowed to identify a benefit promise that is not specified and may not establish terms of the benefit promise that are not already clearly present in the terms of the plan.**

Plans for which the measurement method should not change

8. As noted in Paper A, the staff recommends that the application of the current IAS 19 requirements to plans A, B and C should not be changed.

9. In particular, the net liability in respect of a defined contribution benefit promise is nil and the obligation in respect of a defined benefit promise is measured using the Projected Unit Credit method and a discount rate equal to the yield on AA corporate bonds.

Plans for which the measurement method should change

Asset-based benefit promises

10. Plans D – G illustrate the types of benefit promises for which the staff thinks the accounting should be reconsidered. These are the benefit promises that the staff refers to as asset-based.

11. The staff attempted to select a measurement attribute that would give users decision - useful information about the amount, timing and uncertainty of the future cash flows resulting from the entity's obligation in respect of the benefit promise.

12. As discussed in Paper A, the PUC method gives anomalous results for some benefit promises. One of the reasons for this is that the PUC method attributes no value to options or guarantees that have no 'intrinsic value' (ie because they are currently not expected to occur). An approach which incorporates both the intrinsic value and time value of embedded options and guarantees would

better represent the nature of the entity's obligation. Therefore the staff thinks that a measurement method which represents the time value of guarantees and options would be best suited to the problem in hand.

13. The staff notes further that asset-based benefit promises are similar to derivatives written by the entity, or contracts that include derivatives written by the entity. Under IAS 39, derivatives are measured at fair value.

14. It may be possible, given enough time, to develop a measurement method specific to pension obligations which incorporates the PUC method as well as the optional value of guarantees. It is not clear, though, why such a method may be more faithfully representative than fair value. Moreover, given the time constraints of Phase I, and the fact that fair value is already being used for similar liabilities, the staff does not believe that it would be appropriate to develop a new measurement method for these benefit promises. As such, the staff thinks that asset-based benefit promises should be measured at fair value.

The Approach

15. The approach the staff proposes requires the identification and separation of the components of the benefit promise, so that they could be measured independently and then aggregated in order to determine the accounting for the plan as a whole. The three categories of benefit promises are: defined contribution (DC), defined benefit (DB) and asset-based.

Identification of the benefit promise

16. As the definitions for DB, DC and asset-based benefit promises are mutually exclusive, in many cases it will be fairly straightforward to identify whether a promise is DB, DC or asset-based. Some examples are illustrated in the next few paragraphs.

17. Plan A provides an annual pension income benefit of 5% of final salary for each year of service. This is a benefit promise which changes in line with service and salary and meets the definition of a defined benefit promise.

18. Plan B provides 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. This meets the definition of a defined contribution promise.

19. Plan C provides 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. This benefit relies on future salary increases and a fixed increase of 4% per year and meets the definition of a defined benefit promise.

Avoid arbitrary splitting

20. Plans A and B are examples of plans with one type of benefit promise because it is not possible to separate them into other types of benefit promises without artificially creating promises that are not inherent in the terms of the plan. For instance, the final salary promise in plan A should not be split into a current salary plan plus an additional salary-related guarantee benefit.

21. The staff argues that plans C and E are also examples of plans with a single benefit promise.

22. It may be tempting to categorise the benefit promise in plan C as DC plus a guarantee, because it depends on contributions paid to the plan. However, in this case the guarantee would be a complicated one. Defined contribution promises are identified as the ones where, once the contributions are paid to the plan, the entity has no further obligation in respect of current or prior service. In other words the implied promised rate of return in a DC plan is the actual return on plan assets. Therefore, plan C would have to be split into a DC plan with a maximum and minimum return of 4%, ie a DC plan with a cap and a floor. A similar argument applies to plan E.

23. The staff thinks that it is necessary to prohibit arbitrarily splitting a benefit promise in this way into promises that are not specified in the terms and conditions of the plan. This is needed in order to avoid accounting arbitrage and lack of comparability and consistency.

24. Such a requirement would be analogous to the requirement in section C of the Implementation Guidance in IAS 39 in respect of separating an embedded derivative from a host contract. In IAS 39, the application of this requirement is

left to professional judgement. The staff does not believe that any further guidance is required in respect of benefit promises within the scope of IAS 19.

Therefore the staff recommends that an entity would not be allowed to identify a benefit promise that is not specified and may not establish terms of the benefit promise that are not already clearly present in the terms of the plan.

Separation of the benefit promises

25. For some plans, however, there are two or more benefit promises specified in the terms and conditions. The discussion below focuses on whether a plan with more than one type of benefit promise should be split into separate benefit promises for measurement and then aggregated in order to account for the plan as a whole.

26. In general, the staff thinks that plans should be split into separate benefit promises in order to ensure that the principle of DB accounting for DB benefits (as newly defined) is not undermined.

- Identifying the DB benefit promise first

27. The staff argues that plans which could be described as having DB benefit promises, without artificially creating terms that are not specified in the plan, should be separated into DB and other promises, even if it may be possible to describe such a plan as asset-based in its entirety.

28. Plan D provides a good example of this. It could be described in three different ways:

(a) the whole benefit being an asset-based guarantee (a 'best of option'); or

(b) a DB benefit promise of contributions increased at 3.25% with a guarantee of a DC benefit, if higher (DB host plus option); or

(c) a DC benefit promise with a minimum guarantee of 3.25% (DC host plus option).

29. If the entire benefit were treated as asset-based, it would be measured at fair value, whereas if it were separated into DB and asset-based, the defined benefit promise would be measured using the PUC method, and the asset-based promise would be measured at fair value. Therefore, a different result would be obtained depending on how the benefit promises are identified.

30. At the extreme, a plan with a final salary promise and a guarantee that is highly unlikely to come into effect could be categorised as asset-based in its entirety or as a final salary plan with an asset-based guarantee. If such a plan is treated as asset-based in its entirety, it would be measured at fair value. The staff thinks that this would significantly undermine the DB accounting requirement for traditional DB plans, which is not desirable in Phase one of the project.

31. A similar argument applies in respect of the choice between options (b) and (c) above. Plan F could also be described as having a DC benefit promise with an asset-based guarantee or a DB benefit promise with a different asset-based guarantee.

32. In order to preserve DB accounting for typical DB plans, the staff argues that it is necessary to require DB benefit promises to be given preference over DC promises where there is a choice. If this were not the case, plans with large DB benefits and very small DC underpins would be subject to DC accounting.

- DC plus asset-based promises

33. The argument for separating plans that include only DC and asset-based promises is less convincing.

34. Some would argue that, because asset-based guarantees are measured at fair value, the same accounting measure of the net liability is achieved whether a plan is treated entirely as asset-based or as DC with an asset-based promise. It is tempting therefore to avoid separating DC and asset-based promises.

35. The staff agrees. However, the staff notes that it is necessary to separate DB promises from plans with DB and asset-based promises and plans with DB and DC benefit promises. Therefore, for completeness, the staff recommends that all benefit promises, which can be identified without artificially creating new terms in the benefit promise, are measured separately.

The staff recommends, therefore, that the hierarchy of identification is: DB benefit promises, then asset-based benefit or defined contribution promises.

Comparison of the proposed approach with IAS 19 requirements

36. The proposed approach addresses the main difficulties under IAS 19 in coping with asset-based benefit promises. The approach also requires an explicit identification of the benefit promises in a plan and negates the need to categorise a plan as strictly DB or DC.

37. This approach would allow IAS 19 to account adequately for all the plans that fall within its scope while preserving the current accounting requirements for those plans for which the PUC method is adequate. The staff thinks that the approach, though it may appear to be a significant change at first, is intuitive and gives a result that is faithful to the representation of the liability the entity holds.

38. Both the IAS 19 approach and the new proposed approach apply the same measurement methodology for traditional DB and DC plans. However, they give different results for cash balance and similar plans.

The table below gives a brief comparison of the two approaches:

	Current IAS 19 Approach	**Proposed approach**
Categorisation of plans	DB or DC only	Focus on the nature of the the benefit promises in the plan and not the categorisation of the plan as a whole. Benefit promises may be DB, DC or asset-based.
Definition of DB	Where there is downside risk to the entity.	As for IAS 19, but excludes asset-based promises.

Definition of DC	Where there is no downside risk to the entity	As for IAS 19
Definition of benefits linked to assets or indices	Not applicable	Asset-based promises
Measurement of the DBO	PUC method for DB component, nil net liability for DC component, derivative component is ignored.	PUC method for DB promises, nil net liability for DC promises, fair value for asset-based promises.

Future Deliberations

39. Once the Board has come to a tentative decision in respect of the approach and definitions to be used, the staff will bring a paper covering other corollary issues such as the treatment of annuities, inflation linked benefits, components of pension costs, allocation of salary increases, treatment of variable contribution rates, materiality and measurement difficulties that are likely to arise using the new approach and the components of the pension cost.

Summary of staff recommendations

40. **The staff recommends the separation of the plan into defined benefit, defined contribution and asset-based promises, where applicable. The benefit promises would be measured independently and then aggregated in order to determine the accounting for the plan as a whole.**
41. **Defined benefit and defined contribution plans will continue to be accounted for in accordance with the current IAS 19 requirements. Asset-based benefit promises will be measured at fair value.**
42. **The hierarchy of identification of the benefit promises is: DB benefit promises, then asset-based or defined contribution promises.**
43. **An entity would not be allowed to identify a benefit promise that is not specified and may not establish terms of the benefit promise that are not already clearly present in the terms of the plan.**

APPENDIX A

EXAMPLE PLANS AND APLICATION OF IAS 19 AND THE PROPOSED APPROACH

Plan	Description	IAS 19	Proposed Approach
A	An annual pension income benefit of 5% of final salary for each year of service.	DB	DB
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	DC	DC
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.	DB	DB
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	DB	DB plus asset-based guarantee

Plan	Description	IAS 19	Proposed Approach
	is the actual return on plan assets with a guaranteed minimum return per year of 3.25% (D1)/3.75% (D2).		
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.	DB	Asset-based
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.	DB or DC, whichever is higher	DB plus asset-based

Plan	Description	IAS 19	Proposed Approach
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, 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.	DB	DC for the first fifteen years, DB, DC and asset-based thereafter