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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**19 July 2007, London**
Project:	**Post-employment benefits**
Subject:	**Cash balance and similar plans – Definitions of benefit promises (Agenda paper 7B)**

Objective

1. The objective of this paper is to finalise definitions for *defined benefit, defined contribution* and *defined return* benefit promises.
2. Over the last few months, the Board has discussed various aspects of a new category of post-employment benefit promise, defined return promises. This paper proposes definitions based on the decisions made at those meetings.

Staff recommendation

3. Post-employment benefit plans are composed of *defined benefit, defined contribution* and *defined return* benefit promises. The staff proposes the following revised definitions:
   i. A *defined contribution* promise is a post-employment benefit promise that obliges the employer to pay specified contributions to a separate entity (a fund). Payment by the employer of those specified contributions extinguishes the obligation.

ii. A *defined return* promise is a post-employment benefit promise, which may be funded or unfunded, that obliges the employer to pay a benefit comprised of:

a. a contribution requirement based on current salary; and

b. a promised return on the specified contributions that is linked to the change in an asset or index.

iii. A *defined benefit* promise is a post-employment benefit promise that is neither *defined contribution* nor *defined return.*

A summary of examples of these benefit promises is set out in appendix A.

Defined Contribution Promises

4. Consider the following example of a plan:

Plan 1 The employer promises to pay contributions of 5% of the employee's current salary into a separate fund for each year of service. The benefit promise at retirement is a lump sum equal to the contributions paid combined with the actual investment returns on those contributions.

5. This plan meets the definition of a defined contribution (DC) promise because once the contributions are paid, even if the market value of assets in the plan falls, the employer has no obligation to pay additional amounts either to the plan or directly to the employee.

Does the Board agree the proposed definition for DC promises?

Defined Return Promises

6. DR promises are similar to DC promises in that there is a contribution requirement. However, the DR promise may be funded or unfunded and the entity retains the obligation for the promised return on the contributions until the benefit is paid. Consider the following example:

Plan 2 The employer promises to pay contributions of 5% of the employee's current salary into a fund for each year of service. The benefit promise at retirement is a lump sum equal to the contributions increased with compound interest at the rate of each year's return on a specified equity index.

7. This plan meets the definition of a defined return (DR) promise because the contributions are based on current salary and the defined return is linked to an index.

8. The contribution requirement is based on current salary if the liability at the end of a period can be expressed as the benefit earned by the end of the previous period plus an amount based on this period's salary only, with no additional salary-related factor.

9. The Board decided to draw a distinction between this type of benefit promise and other promises where the contribution requirement cannot be expressed wholly in current salary terms.

10. For instance, consider Plan 3:

Plan 3 The employer promises to pay contributions of 5% of the average of the employee's salary, in the most recent two years of service, for each year of service. The benefit promise at retirement is a lump sum equal to the contributions increased with compound interest at the rate of each year's return on a specified equity index.

11. It is not possible to express the benefit promise in Plan 3 wholly in current salary terms. In other words, the liability at the end of a period cannot be expressed as the benefit earned by the end of the previous period plus an amount based on this period's salary only.

Example: contribution requirement in year 2 = 5% $(Sal_2 + Sal_1)/2$
contribution requirement in year 3 = 5% $(Sal_3 + Sal_2)/2$
$=5\%[(Sal_2 + Sal_1)/2 + Sal_3/2 - Sal_1/2]$

In other words, the contribution requirement at the end of year 3 is the contribution requirement for year 2 ($(Sal_2 + Sal_1)/2$) plus an amount based on the current period's salary ($Sal_3/2$) plus an additional salary-related factor ($- Sal_1/2$). Therefore, plan 3 is DB.

Does the Board agree the proposed definition for DR promises?

Defined Benefit Promises

12. A more typical example of a DB promise is set out below.

Plan 4 The employer promises to pay a lump sum at retirement equal to 5% of the employee's final salary for each year of service.

13. This plan cannot be expressed in terms of current salary with no additional salary-related factor and is, therefore, neither defined contribution nor defined return. It would therefore meet the definition of a defined benefit promise.

Does the Board agree the proposed definition for DB promises?

Combined Benefit Promises

14. Some post-employment plans provide more than one benefit promise. In this case, each benefit promise should be identified and accounted for separately. For example:

Plan 5 – The employer promises 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 return on an equity index.
- For the next 15 years' service, a lump sum equal to 3% of final salary for each year of service.

15. This plan has a DR and a DB benefit promise.

16. Other plans provide the higher of one benefit promise or the other. Paper 7C considers the accounting treatment for plans that provide the higher of two or more promises.

APPENDIX A

Example Plans

Plan 1 The employer promises to pay contributions of 5% of the employee's current salary into a separate fund for each year of service. The benefit promise at retirement is a lump sum equal to the contributions combined with the actual investment returns on those contributions. (**Defined contribution**)

Plan 2 The employer promises to pay notional contributions of 5% of the employee's current salary into a notional fund for each year of service. The benefit promise at retirement is a lump sum equal to the contributions increased each year in line with the return on a specified equity index. (**Defined Return**)

Plan 3 The employer promises to pay contributions of 5% of the average of the employee's salary, in the most recent two years of service, for each year of service. The benefit promise at retirement is a lump sum equal to the contributions increased with compound interest at the rate of each year's return on a specified equity index. (**Defined Benefit**)

Plan 4 The employer promises to pay a lump sum at retirement equal to 5% of the employee's final salary for each year of service. (**Defined Benefit**)

Plan 5 – The employer promises 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 return on an equity index.
- For the next 15 years' service, a lump sum equal to 3% of final salary for each year of service. (**Defined Benefit and Defined Return)**