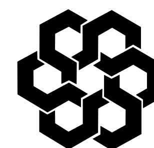

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International Accounting Standards Board

This document is provided as a convenience to observers at Employee Benefits Working Group meetings, to assist them in following the discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

Note: These notes are based on the staff paper prepared for the Employee Benefits Working Group Meetings. Paragraph numbers correspond to paragraph numbers used in the Employee Benefits paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IASB Meeting: **Employee Benefits Working Group**
Paper: **Agenda Paper 4B – Cash balance plans: Definitions of benefit promises**

Introduction

1. In Agenda paper 4A, we noted that the following issues needed to be addressed when dealing with cash balance plans:

   (a) how can cash balance plans be distinguished from other pension plans? What about plans that provide a mixture of cash balance benefits and grandfathered traditional final salary benefits?

   (b) how should benefits be attributed to periods of service in a cash balance plan?

   (c) what is an appropriate measurement attribute for the defined benefit obligation in a cash balance plan?

   (d) how should benefit obligations that depend on a comparison of two amounts be measured?

2. This paper addresses the first and third questions by:

   (a) proposing revised definitions for *defined benefit*, *defined contribution* and *defined return* benefit promises; and

   (b) clarifying the measurement approach applied to these benefit promises.

3. The papers for this meeting do not discuss the second and fourth questions.

Need for revised definitions

4. IAS 19 identified two main categories of post-employment benefit plans: defined benefit and defined contribution plans.

5. Defined contributions plans are those where the "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 have sufficient assets to pay all employee benefits relating to employee service in current and prior service periods."[1] A typical example of this would be a 401(K) plan in the US where contributions are paid on behalf on the employee and the employee assumes the investment risk in the plan. There is no risk to the entity.

6. Defined benefit plans are all plans that do not meet the definition of a defined contribution plan, ie where the entity assumes some risk. A typical example of this would be a final salary plan that promises a pension benefit equal to 2% of final salary for each year of employee service.

7. For some time, typical defined benefit and defined contribution plans were very common. However, during the 1980's and 1990's there was a significant shift away from typical defined benefit and defined contribution plans to plans that have features of both, as well as new features, such as guarantees. As discussed in Agenda paper 4A, these plans are difficult to account for in accordance with IAS 19. The problem is identifying which plans or benefit promises need to be addressed in this phase of the project.

8. A wide variety of plans is in existence. The staff has grouped post-employment defined benefit promises into three groups:

   (a) benefit promises that are based on salary, eg a benefit of 2% of final salary for each year of service. This does not include plans in which the contributions are based on current salary because, once the contributions have been accumulated the benefit is no longer dependent on salary.

   (b) benefit promises that are based on actual or notional contributions and an actual or notional return on those contributions, eg a plan in which the benefit is accumulated through contributions of 5% of salary for each year of service plus the actual return on plan assets with a guaranteed minimum return per year of 3.25%. Some argue

[1] IAS 19, paragraph 7

that many of these plans are simply defined contribution plans with an additional guarantee.

(c) benefit promises that do not vary with salary or contributions, eg post-employment medical care.

A plan may offer a combination of types of benefit promises, for example, the higher of a final salary benefit and a fixed lump sum. The papers for this meeting do not discuss the measurement of obligations which depend on a comparison of two amounts.

9. The Board believes that it is not difficult to apply the IAS 19 methodology for post-employment defined benefits to groups (a) and (c). In the light of the Beard's decision not to address the measurement of typical final salary plans until phase two of the project, these benefit promises are not within the scope of phase one of the project.

10. In its preliminary discussion of the accounting for cash balance and similar plans, the Board concluded that the troublesome benefit promises are those in group (b). The Board observed that a plan may include one or more benefit promises, and that it should focus the accounting on the benefit promises in a plan, not the plan as a whole.

11. Accordingly, the Board asked the staff to propose revised definitions to distinguish clearly between defined benefit and defined contribution benefit promises, and to identify those benefit promises in group (b) separately. The Board proposes to name the benefit promises in group (b) "defined return" because they are based on a specified return on contributions.

Defined contribution promises

12. Consider the following example plan:

Plan 1 The employer promises to make 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.

13. This plan meets IAS 19's definition of a defined contribution plan because once the contributions are paid, the employer has no obligation to pay additional amounts either to the plan or directly to the employee, even if the market value of assets in the plan falls.

14. However, IAS 19's definition of a defined contribution plan excludes benefits that are very similar to defined contribution promises. For example:

Plan 2 The employer promises to make 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.

15. Some contend this plan should be treated in a similar way to Plan 1, ie as defined contribution plus a promised return. However, this plan would not meet the definition of defined contribution in the current version of IAS 19 because the employer has investment risk for the assets.

16. The Board does not intend to change the accounting for plans that meet the current definition of defined contribution plans in Phase 1 of the project. However, the Board will consider extending aspects of the defined contribution accounting to defined return plans if appropriate. This is discussed further in the section on defined return promises. The staff proposes that the definition of defined contribution promises is revised as follows, to help distinguish more clearly between a defined contribution promise and other benefit promises:

    Definition of defined contribution benefit: "A defined contribution benefit promise obliges the employer to make specified contributions to a separate entity (a fund). Payment by the employer of those specified contributions extinguishes the obligation."

Defined return promises

17. Promises similar to those in Plan 2 may:
    (a) be funded or unfunded
    (b) include actual or notional contribution requirements with an explicit or implicit defined return (even if that is a guaranteed 0% return).
    (c) include optionality; in other words, may depend on a comparison of two amounts.

18. The key difference between these promises and defined contribution promises is that the employer retains some risk by promising a *return* on the benefits that have already been earned in current and prior periods. They differ from defined benefit promises

because the risk is a financial risk (for the promised return on investments) rather than a risk related to service or salary.

19. As discussed in paragraph 15, defined return promises, such as those in plan 2, could be considered to be the equivalent of defined contribution promises with an additional risk to the employer in respect of the promised return.

20. The following definition of a defined return promise aims to capture this characterisation and clarify the similarities and differences between defined contribution and defined return plans:

    Definition of defined return promise: "A defined return promise comprises a contribution component and a promised return component.

    The contribution component obliges the employer to make specified actual or notional contributions to an actual or notional fund. Payment by the employer of those specified contributions extinguishes that obligation.

    The promised return component obliges the employer to provide a specified return on the specified contributions. The specified return is linked to the return on the actual or notional fund or to an index."

Defined benefit promises

21. The staff proposes to retain the notion that defined benefit promises are a "catch-all" category. In other words, defined benefit promises would include all promises other than those that meet the definitions of defined contribution or defined return promises. An example of a defined benefit promise is as follows:

    Plan 3 The employer promises to pay the employee an annual pension equal to 1.25% of his final salary at retirement, for each year of service.

22. Typically, defined benefit promises are described as being those in which the employer is exposed to salary, service and/or demographic risks. Demographic risks are risks, such as mortality (or longevity), sickness, resignation and early retirement, that affect the size of the population and, therefore, the amount or timing of benefit to be paid out. For example, some plans may provide annuity promises where the benefit is payable in regular monthly or annual instalments over the life of the employee rather than as a lump sum. In this case, if the retiree lives longer than expected, the employer's ultimate cost of the obligation would increase. In other words, the

employer is exposed to longevity risk (the risk that the retiree lives longer than expected). This benefit promise would meet the definition of a defined benefit promise.

23. However, some argue that demographic risks also exist in promises that would generally be considered as defined contribution or defined return. For example, consider the following plan:

    Plan 4 The employer promises to contribute 5% of the employee's salary into a separate fund for each year of service. The lump sum at retirement, equal to the accumulated contributions with the investment return in the fund, is converted into a pension at a guaranteed annuity rate (ie the cost of buying a pension is fixed, rather than being determined by the market rates at retirement date). That pension amount is payable in regular monthly instalments for the life of the retiree.

24. After retirement, the employer has demographic risk because the cost of the regular monthly instalments varies depending on the longevity of the retiree. However, during the period of employee service, if more (or fewer) employees resign, become ill or die, the cost of the retirement benefit earned will decrease (or increase). This implies that the employer also has demographic risk during the period of employee service. However, this argument could also be extended to most other plans in which the amount of benefit is based on an accumulation of contributions over a period of service. The staff argues that such demographic risk should not exclude promises in which contributions are accumulated over a period of service from being classified as defined return.

25. The staff argues that many plans could be described as being composed of two phases: the accumulation phase during which the benefit is earned and the payout phase when the benefit is paid out. During the accumulation phase, most plans would have some demographic risk in addition to other risks such as salary risk or financial risk. However, the types of risk to the employer may differ once the period of employee service ends. For example, in a final salary plan such as Plan 3, the employer has mortality, salary and service risk during the accumulation phase, but only mortality risk in the payout phase.

26. The staff argues that, although defined benefit promises typically expose the employer to salary, service and demographic risks, those risks are often present in the payout

phase only. Thus, in plan 4, the employer is exposed to longevity in the payout phase, and it is that feature, rather than any risk in the accumulation phase that results in classification as a defined benefit promise.

27. The staff proposes that the definition of defined benefit promises clarify this by noting that only those demographic risks that affect the employer's obligation in respect of the benefit in payment that should be classified as defined benefit, as follows

> *Definition of benefit promises:* "All other benefit promises are defined benefit. Typically, defined benefit promises change in line with service or salary or include demographic risks to the employer while the benefit is in payment."

Measurement of defined return promises

28. As defined in paragraph 20, defined return promises have two components:

    (a) a contribution component; and

    (b) the promised return on those contributions

29. Some argue that these benefit promises are similar to defined contribution promises, which could be similarly divided into two components:

    (a) a contribution component (typically as a percentage of the employee's salary); and

    (b) a promised return on those contributions equal to the actual investment return in the fund.

30. Defined contribution promises would be treated as follows:

	Balance sheet	**Profit and Loss**
Contribution requirement	Recognise liability equal to any unpaid contributions (including the amount of any notional contributions).	Contributions payable
Promised return	Nil – the employer has no obligation in respect of the promised return because this is equal to the actual return on the assets in the plan. Put differently, the liability of nil equals the fair value of the promised return obligation less the fair	Nil – the employer has no obligation in respect of the promised return because this is equal to the actual return on the assets in the plan.

	value of the assets in the actual or notional fund.	

31. For defined return promises, the employer has a present obligation to pay the promised return in past, current and future periods on contributions that have accrued in past and current periods. The Board proposes that this obligation be measured at fair value for the following reasons:

    (a) the PUC method used to measure defined benefit obligations does not attribute any value to options or guarantees that have no 'intrinsic value'. An option or guarantee has no intrinsic value when there is no current expectation that the option or guarantee would be exercised. The Board has concluded tentatively that 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.

    (b) fair value is 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.

    (c) defined return 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.

32. The Board decided that it should not develop a measurement method specific to pension obligations which incorporates both the PUC method and the option value of guarantees. It is not clear that such a method would be more faithfully representative than fair value. Thus, given the time constraints of Phase I, and the fact that fair value is already being used for similar liabilities, the Board decided that it should not develop a new measurement method for these benefit promises.

33. Thus, the approach for a defined return promise would be:

	Balance sheet	**Profit and Loss**
Contribution requirement	Recognise liability equal to any unpaid contributions.	Contributions payable
Promised return	Recognise liability equal to the fair value of the guaranteed return in	The change in the fair value of the guaranteed return, less

	the plan less any plan assets available to satisfy that liability.	the change in the fair value of the plan assets

34. In both cases, the balance sheet asset or liability in respect of the benefit promise is measured net of the plan assets. It is beyond the scope of phase one to consider whether the net presentation is appropriate.

35. The proposed approach results in similar plans receiving similar accounting treatments. For example consider two plans with the same contribution requirement, but where one contains a defined contribution promise and the other contains a promise to make the same contributions and makes a very small additional guarantee of the investment return on those contributions. If this approach is applied, the only difference between the treatments of the two plans would be the recognition of the fair value of the guarantee in the latter benefit.

Questions for participants

Do you agree that employers should classify and account for the individual benefit promises in a plan, rather than the plan as a whole?

Do you agree with the characterisation of the "problem plans" and the definitions of defined contribution, defined return and defined benefit? How would you modify these definitions?

Do you agree with the approach for the measurement for defined return promises?

Do you agree that fair value is an appropriate measurement attribute for the employer's liability to make a promised return? If not, what measurement attribute is appropriate?

APPENDIX A

Example Plans

Plan 1 The employer promises to make 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.

Plan 2 The employer promises to make 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.

Plan 3 The employer promises to pay the employee an annual pension equal to 1.25% of his final salary at retirement, for each year of service.

Plan 4 The employer promises to contribute 5% of the employee's salary into a separate fund for each year of service. The lump sum at retirement, equal to the accumulated contributions with the investment return in the fund, is converted into a pension at a guaranteed annuity rate (ie the cost of buying a pension is fixed, rather than being determined by the market rates at retirement date). That pension amount is payable in regular monthly instalments for the life of the retiree.