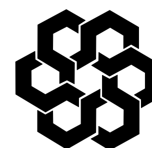

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International Accounting Standards Board

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 4C – Cash balance plans: Promises with fixed returns**

Introduction

1. In paper 4B, the following definitions of defined return and defined benefit promises were discussed:

   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."

   Definition of defined benefit promise: "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."

2. This paper considers the classification of some benefit promises in the context of those definitions, in particular:

(a) benefit promises with fixed returns; and

(b) current salary, career average and other salary-related benefit promises.

Fixed returns

3. An example of a promise with a fixed return is as follows:

Plan 5[1] The employer promises to make 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 plus a fixed return on the contributions of 3% per year.

4. In principle, such a promise meets the definition of a defined return promise. The promise is defined completely by contributions and a specified return on those contributions. Therefore promises with a fixed return should be classified as defined return.

5. However, classifying promises of fixed returns as defined return could potentially extend the scope of Phase I to all post-employment benefits. The problem lies in the classification of career-average salary promises as discussed below.

Salary-related promises

6. A career average promise is one linked to the average of the employee's salary over their entire career. These promises are currently treated as defined benefit (in their entirety) under both IAS 19 and SFAS 87. However, as discussed below, some of these promises are exactly the same as defined return promises with a fixed return.

7. For example, consider the following two benefit promises:

Plan 6 The employer promises to make 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 plus a fixed return of 0% per year.

Plan 7 The employee is entitled to a lump sum benefit equal to 5% of the career average of the employee's salary for each year of service.

8. Using the definitions in paragraph 1, Plan 6 would be classified as defined return with a contribution requirement of 5% of salary and a fixed return of 0%. Plan 7 is a career-

[1] Agenda paper 4B discusses Plans 1-4.

average promise, which many consider to be substantially equivalent to average salary and final salary promises. SFAS 87 and IAS 19 treat career average promises in the same way as final salary promises.

9. However, as illustrated in Appendix A, Plan 6 and Plan 7 provide exactly the same benefit promise, whenever an employee leaves service. The only difference between the two promises is in the way in which the benefit formula is expressed. In principle, since the way in which a benefit is described should not affect how it is accounted for, both promises should be accounted for in the same way.

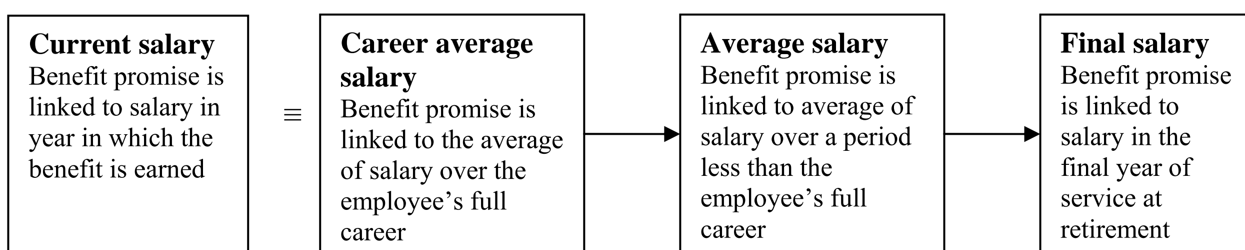
10. The problem is that:

    (a) treating both promises as defined benefit promises does not address the reason for the Board including promises that include a fixed return in the scope of Phase 1, ie that defined benefit accounting is not satisfactory for these promises.

    (b) treating both promises as defined return may imply that all salary-related promises are defined return. In that case, it would be difficult to limit the scope of Phase 1 in a way that does not change the accounting for traditional defined benefit final salary plans.

11. Thus, in order to limit the scope of Phase 1, it is necessary to draw a distinction between some types of salary-related promises and other types of salary-related promises.

12. Salary-related benefit promises exist along a continuum as set out below:



13. This paper discusses three ways of drawing a line along this continuum that would limit the scope of phase one:

    (a) distinguish between current salary and career average promises based on the benefit formula. Current salary promises would be defined return. Career average promises would be defined benefit.

(b) treat current salary and career average promises as identical and treat both as defined benefit. Thus promises with fixed returns (that would otherwise be classified as defined return) would be treated as defined benefit.

(c) distinguish between (i) current salary and career average promises and (ii) all other salary–related promises, based on the salary risk to the employer. Thus current salary and career average promises would be defined return and all other salary-related promises would be defined benefit.

Distinction based on the benefit formula

14. Some may argue that the employee benefit model in IAS 19 places emphasis on the benefit formula. Thus, the classification should depend on how the benefit formula describes the promise. If identical benefits are described and accounted for differently, that is just an unfortunate consequence of an aspect of IAS 19 that it is beyond the scope of Phase 1 of the project to change.

15. Therefore, they would argue that it is possible to distinguish between current salary promises and career average promises using the terms by which they are described. A current salary promise is described in terms of current salary and therefore the entity is deemed not to be exposed to any salary risk. A career average promise is described in terms of past as well as future salaries, so the entity is deemed to be exposed to salary risk in this case.

16. The staff does not agree with this approach. Both promises are the same and are therefore affected in the same way by future salary increases. The same economic promise should be treated in the same way, regardless of the way in which it is described. Comparability across entities would be damaged if the same promises were treated in different ways. Therefore the staff thinks that current salary promises and career average promises should be classified in the same way.

Treating promises with fixed returns as defined benefit

17. This approach would treat current salary and career average salary promises with fixed guaranteed returns as defined benefit. In other words, all the plans in the above continuum would be treated as defined benefit. This classification would apply only to promises with fixed returns, not to other defined return promises with guaranteed returns. For example, promises where the guaranteed return is linked to an equity index would still be treated as defined return.

18. This approach would require the definitions of defined return and defined benefit promises in paragraph 1 to be revised, as follows:

> 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 or to an index and excludes assets or indices linked to fixed returns.
>
> All other benefit promises are defined benefit. Typically, defined benefit promises change in line with fixed returns, service or salary or include demographic risks to the employer while the benefit is in payment.

19. This approach has the advantage that the same promise is treated in the same way (as defined benefit) regardless of whether it is described in current salary or career average terms. Further, the staff is not aware of problems in practice in applying defined benefit accounting to such promises.

20. However, this approach makes the definitions more complex to describe and apply. It also creates an exception to the conceptual basis underlying the definitions. Further, as discussed below, the staff thinks that it is possible to distinguish between (i) current salary promises and career average promises and (ii) other salary-related promises. This enables the former group to be treated as defined return promises without extending the scope of defined return promises to all salary-related promises. Therefore the staff does not recommend that the classification of fixed return promises is changed.

Distinction based on salary risk to the entity

21. The staff argues that it is possible to distinguish between (i) current salary promises and career average promises and (ii) other average salary promises and final salary promises.

22. The distinction depends on whether the salary related benefit can be expressed wholly in current salary terms. If it can be so expressed, the benefit for a given period is unaffected by future salary increases, and would be classified as defined return. If not the benefit for the period is affected by future salary increases, and would be classified as defined benefit.

23. For instance, consider promise 8:

Plan 8 The employee is entitled to a lump sum benefit equal to 5% of the average of the employee's salary, in the most recent two years of service, for each year of service.

24. Appendix B shows that it is not possible to express the benefit promise in Promise 8 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. Contrast this with Promise 7 where the benefit promise could be expressed in current salary terms (ie Plan 7 could be expressed in the same way as Plan 6).

25. It may seem counterintuitive to assume that an entity is at risk in respect of future salary increases, when the salary averaging period is any period between 1 and the full career, but extending the averaging period to the full career suddenly removes that risk because the benefit promise could be expressed as a current salary promise.

26. The staff thinks that this anomaly arises because there is a fundamental difference in the IAS 19 accounting requirements for contribution requirements as opposed to other types of benefit promises. Phase I of this project will not be change this aspect of defined benefit accounting.

27. This approach allows identical economic benefit promises (ie current salary and career average promises) to be accounted for in the same way. It draws a clear, non-arbitrary line between current salary/career average promises and other salary-related benefit promises and does not require a change in the definitions proposed.

28. However, some constituents might find it difficult to understand why career average promises are classified differently from other average and final salary promises. As noted above, SFAS 87 and IAS 19 treats such promises as similar to final-salary benefits. Therefore the approach could be seen as a significant change to the accounting for some career average promises to which the application of SFAS 87 and IAS 19 has been regarded as relatively straight-forward.

Questions for participants

Which approach do you think is the most appropriate? Why?

If the Board were to propose any of these approaches, how many plans would be affected? What practical difficulties would they face?

APPENDIX A

Comparison of Plans 6 and 7

Consider the following promises:

Plan 6: The employer promises to pay notional contributions of 5% of the employee's salary into a notional fund for each year of service. The benefit promise at retirement is a lump sum equal to the contributions plus a fixed return of 0% per year.

Plan 7: The employee is entitled to a lump sum benefit equal to 5% of the career average of the employee's salary, with no revaluation, for each year of service.

Plans 6 and 7 provide the same amount of benefit in all circumstances, if the averaging period for salary increases is the same as the qualifying service period for the benefit promise. This is because the sum of the benefit in each year (Plan 6) is equal to the average benefit multiplied by the number of years (Plan 7). Therefore, as shown in the table below, both promises are equivalent.

Year	Salary	Plan 6 benefit if employee left in this year	Career Average Salary	Plan 7 benefit if employee left in this year
1	85	5% x 85 = **4**	= 85	5% x 85 x 1 yr = **4**
2	105	5% x 105 + 4 = **10**	= (85 + 105)/2 = 95	5% x 95 x 2 yrs= **10**
3	110	5% x 110 +10 = **15**	= (85 + 105 + 110)/3 = 100	5% x 100 x 3 yrs = **15**

More generally,

At any time (t), the benefit in Plan 6 is equivalent to that in Plan 7 as shown below:

Let Sal(t) be the salary at time t

The benefit in Plan 6 is the accumulation of 5% of salary in current and prior years.

= 5% x Sal (t) + 5% x Sal (t-1) + 5% x Sal (t-2) + …… + 5% x Sal (1)

= 5% x t/t x [Sal (t) + Sal (t-1) + Sal (t-2) + …… + Sal (1)]

=5% x t x [Sal (t) + Sal (t-1) + Sal (t-2) + …… + Sal (1)]/ t

= 5% x service x career average of salary

= the benefit in Plan 7

Therefore, the difference between Plan 6 and Plan 7 is simply the way in which the benefit formula is expressed.

APPENDIX B

Benefit promise earned in Plan 8

Consider the following promise:

Plan 8: The employee is entitled to a lump sum benefit equal to 5% of the average of the employee's salary in the most recent two years of service, for each year of service.

Year	**Salary**	**Two year Average Salary**	**Plan 8 benefit if employee left in this year**	**Plan 8 benefit earned in each prior year if employee left in this year**
1	85	= 85	5% x 85 x 1 yr = **4**	Year 1: 5% x 85 = 4
2	105	= (85 + 105)/2 = 95	5% x 95 x 2 yrs= **10**	Year 1: 5% x 85 + 5% x (95-85) Year 2: 5% x 95
3	110	= (105 + 110)/2 = 108	5% x 108 x 3 yrs = **16**	Year 1: 5% x 85 + 5% x (95-85) + 5% x (108-95) Year 2: 5% x 95 + 5% x (108-95) Year 3: 5% x 108

APPENDIX C

Example Plans

Plan 5 The employer promises to make 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 plus a fixed return on the contributions of 3% per year.

Plan 6 The employer promises to make 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 plus a fixed return of 0% per year.

Plan 7 The employee is entitled to a lump sum benefit equal to 5% of the career average of the employee's salary, with no revaluation, for each year of service.

Plan 8 The employee is entitled to a lump sum benefit equal to 5% of the average of the employee's salary, in the most recent two years of service, for each year of service.