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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**20 June 2007, London**
Project:	**Post-employment benefits**
Subject:	**Benefit allocation (Agenda papers 6A and 6B)**

PAPER 6A: BENEFIT ALLOCATION FOR DEFINED RETURN PROMISES

Introduction

1. At its May 2007 meeting, the Board decided that benefit promises should be categorised as defined benefit, defined return or defined contribution.

2. The Board tentatively decided that a defined return promise had two components:

    a. a contribution component that obliges the employer to make specified contributions. Those contributions may be funded or unfunded.

    b. a promised return component that obliges the employer to provide a specified return based on the contribution component. The specified return may be an actual return on contributions or a hypothetical return on notional contributions. It may be a fixed return, or it may refer to specified assets or an index.

3. The accounting for defined benefit and defined contribution promises will be the same as for defined benefit and defined contribution plans in IAS 19. The Board decided that:

    a. the contribution component is measured as the sum of the accumulated unpaid contributions (but see agenda paper 6C).

    b. the promised return component is measured as the fair value of the promised return less any plan assets available to satisfy that liability

4. This paper discusses specific issues arising in the recognition and measurement of defined return promises, in particular:

    a. whether unvested defined return promises should be treated as liabilities in phase 1 of the post-employment benefits project.

    b. how the benefit under a defined return promise should be attributed to periods of employee service.

Staff recommendations

5. The staff recommends that:

    a. the Board regards unvested benefits under a defined return promise as giving rise to a liability in phase I of the post-employment benefits project.

    b. for defined return promises:

        i. the benefit under the contribution element of a defined return promise is allocated to periods of service in line with the benefit formula, even if the benefit formula specifies a materially higher level of contributions in later years.

        ii. the benefit created by the fair value of the defined return component is recognised in the period in which the related contribution is allocated.

Staff analysis

Unvested benefits

6. A defined return promise may have vesting conditions attached to it. For example, an employee might only be entitled to the benefit from a defined return plan if he stays with the company for two years.

7. The staff argues that the effect of vesting conditions for defined contribution promises and the contribution component of defined return promises should be consistent because the obligation is the same. However, IAS 19 does not discuss vesting conditions for defined contribution promises.

8. For defined benefits, the Basis for Conclusions to IAS 19 argues that "an entity has an obligation under a defined benefit plan when an employee has rendered service in return for the benefits promised under the plan"[1] and notes that "an obligation exists even if a benefit is not vested."[2] Accordingly, IAS 19 treats unvested defined benefit promises as liabilities.

9. To be consistent with the arguments in IAS 19, the Board could decide that promises to pay defined return benefits are liabilities, regardless of whether there are any vesting conditions.

10. However, there is a question as to whether unvested benefits meet the definition of a liability in IAS 37. Some argue that unvested benefits represent a constructive obligation in IAS 37 and thus a liability should be recognised. Others argue that no *present* obligation exists for unvested benefits, or that no obligation exists because the employer can take action to avoid the outflow of economic resource, eg by terminating the employee's contract before the benefits vest.

11. In the staff's view, the question of whether there is a liability for unvested benefits is a question for phase II of this project. It would not be appropriate to address this fundamental question about benefit accounting in phase I of the project. **Accordingly, the staff recommends that the Board regards unvested**

[1] Paragraph 13 of the Basis for Conclusions to IAS 19

[2] Paragraph 14 of the Basis for Conclusions to IAS 19

benefits under a defined return promise as giving rise to a liability in phase I of the post-employment benefits project.

Allocation of benefits

12. The second question is how to allocate the benefits given under a defined return promise to periods of service. A liability then arises for the benefits allocated to past periods of service.

13. The two components of the defined return promise are discussed separately.

The contribution component

14. In relation to the contribution requirement, the obvious answer may seem to be that the benefit that should be allocated to any period of service is the contribution required for that period. In IAS 19 terminology, this is equivalent to requiring the benefit to be allocated in accordance with the benefit formula. Doing so would be consistent with the treatment of benefits under a defined contribution plan.

15. Consider a defined return promise which provides a benefit of contributions of 5% of current salary for the first ten years of service and 10% for the next ten years, with some defined return on those contributions. If there were no defined return element and the promise was a defined contribution promise, the fact that the benefits earned in later periods are higher than the benefits earned in early periods would not affect the accounting. No accrual would be made in the early periods for the higher benefits to be earned in the later periods.

16. In contrast, if the plan were a defined benefit promise, IAS 19 would require the benefits to be attributed to periods of service on a straight-line basis. One reason for this requirement is to prevent entities from avoiding the recognition of a liability for unvested benefits by setting the benefit formula so that the whole benefit is earned in the last period of service.

17. Consider the following example. There is no difference between (a) a benefit of 100 per year that does not vest until the end of 20 years and (b) a benefit of 2,000 that is earned and vests at the end of 20 years. However, if the liability recognised is based on the benefit formula, (a) would result in a liability of 100 each year and (b) would result in no liability recognised until the 20^{th} year.

18. The staff acknowledges that sticking to the benefit formula could result in an entity not recognising some unvested benefits. However, the risk applies only to unvested benefits. If the benefit in 16(a) vested at the end of each period, it would not be possible to delay recognition of the liability by expressing the benefit in a different way. All *vested* benefits attributed to past service are recognised.

19. In paragraph 11, the staff argued that unvested benefits should be treated as giving rise to a liability. That might imply that we should not allow entities to avoid recognising that liability by always sticking to the benefit formula. But, departing from the benefit formula for the contribution component of the defined return promise would complicate the measurement of both the contribution and the defined return components. The Board has decided to measure the defined return component at fair value. The defined return component must specify the contributions for which the defined return is promised. If the contributions are allocated other than in accordance with the benefit formula, the defined return component would be measured as the fair value of a defined return on allocated contributions. The staff thinks that this would add complexity to the approach without the benefit of giving more meaningful information. For example, to measure the fair value of allocated contributions, the Board would need to decide whether the allocated benefit includes the effect of expected future salary increases. This question has arisen for defined benefit promises (see paper 6B) but does not arise when the contribution component is allocated in accordance with the benefit formula.

20. Finally, allocating the contribution component other than in accordance with the benefit formula would weaken the comparison between the contribution component of a defined return promise with a defined contribution promise. Many Board members have strongly supported this comparison.

21. The staff therefore recommends that the benefit under the contribution element of a defined return promise is allocated to periods of service in line with the benefit formula.

The promised return component

22. The defined return is always a defined return on contributions. So the benefit given by the defined return on a contribution must be allocated to the period to

which the contribution is allocated. There is no separate allocation question to address.

23. The implications of this are as follows. At any point in time, the promised return component comprises:

   a. a defined return on contributions required for past and current periods; and

   b. a defined return on contributions required in future periods.

24. Under the staff proposal above, a liability for the defined return in (a) will be recognised in the periods for which the related contributions are required. No liability will be recognised for the defined return in (b) because the benefit of the contributions is attributed to future periods of service.

25. The staff recommends that the benefit created by the fair value of the defined return component is recognised in the period in which the related contributions in allocated.

PAPER 6B: BENEFIT ALLOCATION FOR DEFINED BENEFIT PROMISES

Introduction and background

26. IAS 19 requires that the benefit in defined benefit plans is attributed to periods of service in accordance with the benefit formula, unless the benefit formula would result in a materially higher level of benefit allocated to future years. In that case the benefit is allocated on a straight line basis (paragraph 67 of IAS 19). FAS 87 contains a similar requirement for the attribution of plans that "have benefit formulas that attribute all or a disproportionate share of the total benefits provided to later years of service"[3].

27. In the deliberations leading to D9 *Employee Benefits with a Promised Return on Contributions or Notional Contributions*, the IFRIC considered whether expected increases in salary should be taken into account in determining whether a benefit formula expressed in terms of current salary allocates a materially higher level of benefit in later years.

[3] FAS 87, paragraph 42

28. The IFRIC concluded that future salaries should be included in assessing if the benefits are higher in later years of service. It reflected its conclusion in the paragraph IE4 of the illustrative examples to D9 (reproduced in the appendix). However, there was considerable opposition to this conclusion in the comment letters to D9. Respondents stated that the IFRIC's implicit conclusion that future salary increases lead to non-level benefits is a significant change in practice and one with implication beyond the cash balance plans discussed in D9.

29. In this paper, the staff considers whether the Board's decisions on the allocation of benefits to periods of service for defined return plans (see Agenda Paper 6A) have implications for defined benefit plans that should be addressed by the Board or the IFRIC in Phase 1 of its post employment benefits project.

Staff recommendations

30. The staff recommends that the Board ask the IFRIC to develop a separate Interpretation on whether, for defined benefit promises, expected increases in salary should be taken into account in determining whether a benefit formula expressed in terms of current salary allocates a materially higher level of benefit in later years.

Staff analysis

31. The IFRIC did not reconsider its decision in D9 that expected increases in salary should be taken into account in determining whether a benefit formula expressed in terms of current salary allocates a materially higher level of benefit in later years. The Board's project on post-employment benefits had begun and the IFRIC decided to wait to see what implications might be drawn from the Board's deliberations about cash balance plans.

32. The staff recommendations in paper 6A that defined return promises are not allocated to periods of service apply to defined return promises. Defined return promises include the type of promises that were considered by the IFRIC in D9 and to which the IFRIC conclusion about expected salary increases applied. So it could be argued that there is nothing left for the IFRIC to consider.

33. However, the staff agrees with the respondents to D9 that argued that the issue applies more broadly. It applies also to promises that would continue to be

classified as defined benefit promises under the Board's proposals. The staff notes that Phase 1 of the post-employment benefits project does not envisage changes to the accounting for typical defined benefit arrangements. Accordingly, the staff argues that this issue as it applies to defined benefit promises should be addressed by the IFRIC through an Interpretation of IAS 19.

34. **The staff recommends that the Board ask the IFRIC to develop a separate Interpretation on whether, for defined benefit promises, expected increases in salary should be taken into account in determining whether a benefit formula expressed in terms of current salary allocates a materially higher level of benefit in later years.**

APPENDIX

Extract from the illustrative examples to D9 Employee benefit plans with a promised return on contributions or notional contributions*. The IFRIC reflected its conclusion that salary increases should be taken to account in determining whether a benefit formula attributes materially higher benefits to later periods of service in paragraph IE4.*

Numerical example

IE3 Consider a plan under which a contribution of 10 per cent of current salary is paid and the employees receive the higher of the actual return on plan assets and an annual return on the contribution of 4 per cent per year over the period to when the benefits are paid. Assume also that expected salary increases are 7 per cent per year and the contributions are due and are made at the beginning of the year.

IE4 The fixed component of the plan is the contributions plus the guaranteed 4 per cent return. The variable component is the contributions plus the actual return on plan assets. The fixed component benefits projected over an expected service life of five years are as follows.

	Year 1	Year 2	Year 3	Year 4	Year 5	Total per the benefit formula	Benefit allocated on a straight-line basis*
Year 1 benefit	100.0 (contribution) 4.0 (return)	4.2† (return)	4.3 (return)	4.5 (return)	4.7 (return)	121.7	128.9
Year 2 benefit		107.0§ 4.3	4.5	4.6	4.8	125.2	128.9
Year 3 benefit			114.5 4.6	4.8	5.0	128.9	128.9
Year 4 benefit				122.5 4.9	5.1	132.5	128.9
Year 5 benefit					131.1 5.2	136.3	129.0
Total benefit						644.6	644.6

* Paragraph 67 of IAS 19 requires benefits to be allocated on a straight-line basis if the benefit formula attributes materially higher benefits to later periods of service. For the purposes of this example, it is assumed that the benefits attributed to later years of service are materially higher.

† 4.2 is the return of 4% on the asset balance of 104 (100 plus 4) at the end of year 1.

§ The contribution has increased by 7% since year 1 because of salary increases.