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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **20 June 2007, London**

Project: **Post-employment benefits**

Subject: **Inflation (Agenda paper 6D)**

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1. The objective of this paper is to clarify the classification of benefit promises linked to inflation. This paper considers only benefits linked to inflation during the service period of the employee. The treatment of benefits in payment in general will be discussed at the July meeting.

Background

2. At the May meeting the Board tentatively decided to adopt revised definitions for *defined benefit*, *defined contribution* and *defined return* benefit promises.

3. A defined return promise is comprised of a contribution requirement and a promised return on those contributions.

> The contribution requirement obliges the employer to make specified actual or notional contributions to a funded or unfunded arrangement.

Payment by the employer of those specified contributions extinguishes that obligation.

The promised return component obliges the employer to provide a defined return on the specified contributions. That defined return is linked to the change in an asset or index.

4. All other benefit promises (ie excluding defined contribution and defined return promises) are *defined benefit*. Typically, defined benefit promises change in line with service or salary (ie promises that cannot be expressed wholly in current salary terms) or include demographic risks to the employer while the benefit is in payment.

5. The definitions of benefit promises are, largely, mutually exclusive. However benefit promises linked to wage inflation could be thought to be either defined benefit or defined return. For example, consider the following plan:

Plan A For each year of service, the employee will receive a lump sum benefit equal to 5% of revalued salary. The revalued salary is the salary, in the year in which it is earned, increased in line with the increase in the national average earnings index over the period to retirement.

6. Such a benefit promise is linked to an index, so might be thought to be defined return. However, the benefit also cannot be expressed wholly in current salary terms, without revaluation in line with the national average earnings index. If the national average earnings index is regarded as a salary related factor, the benefit might be thought to be defined benefit.

7. The staff recommends that the Board clarifies whether benefit promises linked to inflation indices should be classified as defined benefit or defined return.

Staff Recommendation

8. The staff recommends that:

   (i) benefit promises with a promised return on contributions that is linked to wage inflation are classified as defined benefit.

(ii) benefit promises with a promised return on contributions that is linked to assets or indices, eg consumer price inflation, are classified as defined return.

Staff analysis

9. In some jurisdictions salary increases and salary-related benefit promises may be linked to a wage or average earnings index. An example of such a benefit promise is as follows:

Plan A For each year of service, the employee will receive a lump sum benefit equal to 5% of revalued salary. The revalued salary is the salary, in the year in which it is earned, increased in line with the increase in the national average earnings index over the period to retirement.

10. It is arguable that Plan A is simply another way of describing a salary-related defined benefit promise. The benefit promise cannot be expressed in current salary terms only, because the revaluation is salary-related. In fact, if the employee's actual earnings increase in line with the national average earnings index, Plan A would provide exactly the same benefit as the following final salary benefit.

Plan B For each year of service, the employee will receive a lump sum benefit equal to 5% of the final salary at retirement.

11. However Plan A could also be described as a defined return promise ie as a benefit promise with a contribution requirement of 5% of current salary and a promised return in line with the relevant earnings index. If Plan A (benefit promise linked to wage indices) is classified as defined return and Plan B (the same benefit promise linked to actual salary increases) is classified as defined benefit, this would lead to very different accounting for the same economic benefit.

12. The staff thinks that any benefit promise linked to a wage inflation index should be classified as defined benefit because:

(i) such a benefit promise is, in substance, a salary-related defined benefit promise, even if the salary to which it is related is national average earnings not the employee's actual salary.

(ii) constituents have not raised problems in measuring benefit promises linked to wage inflation indices using the projected unit credit method in IAS 19.

(iii) classifying these promises as defined return would result in a significant change in the accounting for many salary-related benefit promises. In particular, a defined return classification would require the employer to fair value a salary-related promise. The Board decided previously that salary-related promises would continue to be measured using the projected unit credit method.

24. Benefit promises with a return on contributions linked to other , non-salary related, types of inflation fall clearly within the definition of defined return promises and should be treated as such.