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International
Accounting Standards
Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **18 May 2007, London**

Project: **Post-employment benefits**

Subject: **Definitions of benefit promises (Agenda paper 10A)**

Objective

1. The objectives of this paper are:

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

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

Background

2. At the previous meeting, the staff proposed definitions for three categories of benefit promises. The Board noted the following:

   o Some benefit promises appear to be simply defined contribution with a guarantee. However, the proposed definitions do not allow these plans to be treated as such.

- The term asset-based is misleading and does not fully capture other characteristics of the benefit promises that fall within this category.

- Some Board members thought that pension payments should be classified as defined benefit when they include longevity risk to the employer.

3. The Board asked the staff to propose a new term for asset-based promises and new definitions to more clearly identify the characteristics of the three categories of benefit promises.

Assumptions

4. This paper is based on the following assumptions:

(i) There are three types of benefit promises: defined benefit, defined contribution and defined return. These benefit promises give rise to three different types of benefit obligations.

(ii) A post-employment benefit plan may be composed of any one or more of those three benefit promises.

(iii) The definitions in this paper apply to the benefit promises only (ie not to the plan as a whole).

Staff recommendation

5. Post-employment benefit plans are composed of *defined benefit*, *defined contribution* and *defined return* benefit promises. Some plans may have one or more benefit promise (see Appendix A for examples). The staff proposes the following definitions:

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

These benefit promises are accounted for in accordance with current IAS 19 requirements for defined contribution plans.

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

The contribution requirement obliges the employer to pay 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 defined return on the specified contributions. That defined return is linked to the change in an asset or index.

The employer's liability for the contribution requirement is measured as the sum of the accumulated unpaid contributions. The employer's liability for the promised return component is measured as the fair value of the promised return less any plan assets available to satisfy that liability.

iii. 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.

These benefit promises are measured in accordance with the current IAS 19 requirements for defined benefit plans.

6. Defined return is the new suggested term for the benefits previously described as 'asset-based'. It captures the key characteristic of these benefits and is more consistent with the nomenclature used for the other benefit promises.

Defined Contribution Promises

7. 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.

8. This plan meets IAS 19's definition of a defined contribution (DC) plan 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.

9. The Board has noted that this definition of a DC plan excludes benefits that are very similar to defined contribution promises.

10. 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.

11. Some Board members thought that this plan should be treated as DC plus a guaranteed return. A plan is DC under the current IAS 19 requirements only if it is funded and the promised return on contributions is equal to the actual return on plan assets. A benefit defined in terms of notional contributions and returns on a notional fund of assets creates risk for the entity and, therefore, is not DC. Including benefit promises where there is risk to the entity (for eg Plan 2) as DC would require a change in the accounting for a DC promise.

12. The Board decided previously that the accounting for DC promises would not be changed in Phase I of the project. Moreover, an appropriate accounting treatment for Plan 2, which gives the same result as treating the benefit promise as DC plus a guarantee, can be achieved by categorising these benefit promises as defined return promises (formerly asset-based) as explained in the next section.

13. The staff proposes the following definition of defined contribution promises to help distinguish more clearly between a defined contribution promise and other benefit promises.

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

Does the Board agree the revised definition of defined contribution promises?

Defined Return promises (formerly asset- based)

14. At the last meeting the staff proposed the following definition for asset-based promises:

> An asset-based benefit promise is one whose amount changes in response to the change in an asset or index, other than assets or indices that yield fixed and retail price inflation (or its equivalent) increases. These benefit promises are measured at fair value[1].

15. Plan 2 (paragraph 10) is an example of this type of benefit promise.

16. The Board noted that the term asset-based was potentially misleading and also asked the staff to consider revising the definition to clarify the treatment of benefits such as those in Plan 2.

Defined return vs Asset-based

17. The key characteristics of promises such as those in Plan 2 and other (formerly termed) asset-based promises include the following:

    - The employer retains some risk in respect of the promised *return* on the benefits that have already been earned in current and prior periods.
    - The benefit promise may be funded or unfunded
    - The benefit promise may include actual or notional contribution requirements
    - The benefit promise may include optionality

18. As noted previously, the key difference between these promises and DC benefit promises is that, for plans such as Plan 2, the employer is at risk for the promised return on benefits that have already been earned. In this case, the risk

[1] The treatment of guaranteed fixed returns (fixed increases) will be dealt with in Paper B.

is a financial risk in respect of the benefit promise rather than a risk related to service or salary.

19. In deriving a new name for this category of benefit promises, the staff noted: (i) these key features and (ii) that the system for naming the other benefit categories relies on a focus on the aspect which defines the employer's key obligation, *viz* defined contribution (DC) and defined benefit (DB).

20. Accordingly, the staff recommends the term Defined Return (DR). This term achieves the following objectives[2]:

    - it implies, by analogy to the other terms (DB and DC), that the promised return is the key risk that the employer holds;

    - it allows for the assets to which the promised return is linked to be actual or notional;

    - it allows, implicitly, for actual or notional contribution requirements since all contribution requirements must have an explicit or implicit defined return (even if that is a guaranteed 0% return);

Does the Board agree the use of the term Defined Return for these types of benefit promises?

Definition of defined return benefit promises

21. As discussed previously, DR promises, such as those in plan 2, could be constructed as 'DC – like' with an additional risk to the employer in respect of the promised return.

22. The following revised definition of a DR promise aims to capture this characteristic and clarify the similaririties and differences between DC and DR plans:

[2] The term *defined return* does not explicitly include optionality between benefit promises. The staff will bring a separate paper to the Board to discuss the treatment of plans with combined benefit promises or which provide a choice between two or more benefit promises.

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

The contribution requirement obliges the employer to pay 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 defined return on the specified contributions. That defined return is linked to the change in an asset or index.

Does the Board agree the proposed definition of defined return benefit promises?

Measurement

23. Defined return promises have two components:

(i) A contribution requirement

(ii) The promised return on those contributions

24. This is, in fact, the same as a DC plan, which has a contribution requirement (typically as a percentage of the employee's salary) and a promised return on those contributions (equal to the actual investment return in the fund).

25. Accordingly, the staff thought that it would be useful to consider the accounting for a DC plan when determining how the employer's obligation in a DR plan should be accounted for. An alternative approach for accounting for a DR plan would be to treat it as analogous to the accounting for a DB plan, as set out in Appendix B. Both approaches give the same net result. The staff recommends that both approaches are included in the Discussion Paper. Staff experience indicates that some constituents may find the DC analogy intuitive and the DB analogy difficult, other constituents may have the opposite reaction.

26. The accounting for a DC plan is as follows:

Balance Sheet:

Contribution requirement – Liability equal to any unpaid contributions

Promised return – Nil – the employer has no obligation in respect of the promised return.

The employer has no further obligation in respect of the contribution requirement once the contributions are paid. Therefore the employer is only required to account for the contributions due. The obligation in respect of the contribution requirement is measured net of plan assets.

Profit and Loss

Contribution requirement – Contributions payable

Promised return – Nil – the employer has no obligation in respect of the promised return since this is equal to the actual return on the assets in the plan.

27. An analogous approach for a DR plan is set out below. This approach also measures the balance sheet asset or liability in respect of the benefit promise net of the plan assets.

Balance Sheet:

Contribution requirement – Liability equal to any unpaid contributions

Promised return – Liability equal to the fair value of the guaranteed return in the plan less any plan assets available to satisfy that liability.

The employer has an obligation in respect of the promised return. This is measured at fair value and is equal to the promised return already accrued on the specified contributions payable in respect of current and prior service plus the fair value of the guaranteed future returns on the specified contributions payable in respect of current and prior service.

The excess, if any, of plan assets over contributions paid would offset this obligation. Therefore the net liability in respect of the promised return is the fair value of the guaranteed return less the excess, if any, of plan assets over the contributions paid.

28. Similarly the *Profit and Loss* charge could be determined as follows:

Contribution requirement – Contributions payable

Promised return – The change in the fair value of the guaranteed return

The staff will bring a separate paper to discuss whether the profit or loss charge should be analysed into components.

29. The advantage of the proposed approach above is that it results in similar plans receiving similar accounting treatments. For example consider two plans with the same contribution requirement, but where one is DC and the other promises a return equal to the actual investment return in the plan plus a very small additional guarantee. Under the above proposals, the only difference between the accounting for the two benefit promises would be the recognition of the fair value of the guarantee in the latter benefit.

30. Therefore the staff recommends that the employer's net liability in respect of the contribution requirement is measured at the sum of any unpaid contributions and the employer's net liability in respect of the promised return on the contributions is measured at the fair value of the promised return less the excess of any plan assets over the contributions payable. The staff proposes to bring a separate paper to discuss the components of profit and loss in respect of a DR plan at a subsequent meeting.

Does the Board agree the proposed approach for measuring the employer's obligation in respect of a DR plan?

Defined Benefit promises

31. The previously proposed definition of the defined benefit promise includes all benefit promises that are neither defined contribution nor defined return. The staff proposes to retain this notion.

32. An example of a DB promise is as follows:

Plan 3 The employer promises to pay the employee a lump sum equal to 3% of his final salary at retirement, for each year of service.

33. Some plans may provide annuity promises where the benefit is payable in regular monthly or annual instalments rather than as a lump sum. In this case, if the retiree lives longer than expected, the employer's obligation in respect of the benefit promise would increase. In other words, the employer is exposed to longevity risk (the risk that the retiree lives longer than expected).

34. The Board asked the staff to consider whether risks such as the longevity risk in promised pension payments should cause a benefit to be classified as defined benefit.

35. DB promises, as the name implies, are those promises where the employer's obligation (and retained risk) is in respect of the benefit in payment. Since longevity risk in a pension payment affects the employer's obligation in respect of the benefit payment, this would imply that longevity risk causes a promise to be classified as DB. Moreover, it is clear that longevity risk does not fall within either the DC or DR benefit promise categories as longevity is not linked to assets or indices. Therefore, the staff thinks that benefit promises such as annuity payments should be classified as defined benefit if the employer retains the longevity risk in respect of those payments.

36. Longevity risk belongs to a larger family of risks common in a pension plan called demographic risks. These are the risks that affect the size of the population and, therefore, the amount of benefit to be paid out. Example risks are mortality, sickness, resignation and early retirement.

37. The staff considered whether these other demographic risks should be classified as defined benefit and noted that it is only those demographic risks that affect the employer's obligation in respect of the benefit in payment that should be classified as DB.

38. For example, consider the following plan:

The employer promises to pay contributions of 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.

39. This pension plan could be described as being composed of two phases: the accrual phase during which the benefit is earned and the payout phase when the benefit is paid out.

40. During the accrual phase, if more (or fewer) employees resign, become ill or die than expected, for instance, the amount of the normal retirement benefit earned will decrease (or increase). However, demographic risks such as these are common to most promises (in the accrual phase). If the presence of a demographic risk always causes a promise to be classified as DB, many plans which the staff thinks should be classified as DR (eg Plan 2) would become DB. Therefore the staff thinks that demographic risks in the accrual phase of a promise should not cause that promise to be classified as DB.

41. Some risks, however, may affect the amount of the benefit in payment only (ie they have an effect in the payout phase only). For example, in the plan above, the employer is exposed to longevity risk once the benefit is in payment. However, this risk does not affect the employer’s obligation in respect of the 5% contribution requirement or the promised return on those contributions.

42. Other examples of this type of risk are duration of illness in a post-retirement medical plan and spouse’s mortality risk during the pension payout phase of a typical final salary plan.

43. The staff thinks that it is the existence of a demographic risk while the benefit is being paid out that differentiates DB plans from other plans and has revised the proposed definition of DB promises to reflect this:

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.

Does the Board agree the proposed definition of Defined Benefit 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 the employee a lump sum equal to 5% of his final salary at retirement, for each year of service. (**Defined Benefit**)

Plan 4 The benefit promise at retirement is a lump sum equal to accumulated notional contributions of 5% of the employee’s current salary for each year of service plus the promised return. The promised return is the increase in a specified equity index or the increase in a notional portfolio of assets, whichever is higher. (**Defined Return with optionality between two defined return promises)**

Plan 5 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, or a lump sum equal to contributions of 5% of the employee’s current salary for each year of service increased in line with a specified equity index, if higher. (**Defined Return with optionality between a defined contribution and defined return promise,**

Plan 6 The employer promises to pay the employee a lump sum equal to 5% of his final salary at retirement, for each year of service, or a lump sum equal to notional contributions of 5% of the employee's current salary for each year of service increased in line with a specified equity index, if higher. (**Defined benefit with optionality between a defined benefit and defined return promise)**

Plan 7 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, or a lump sum equal to 5% of his final salary at retirement for each year of service, if higher. (**Defined Benefit with optionality between a defined contribution and defined benefit promise)**

Plan 8 The employer promises to pay the employee a lump sum equal to 40% of either his final salary at retirement or his career average of salary, whichever is higher. (**Defined Benefit with optionality between two defined benefit promises)**

APPENDIX B

MEASUREMENT OF THE LIABILITY

FOR A DEFINED RETURN BENEFIT

B1 There are two possible approaches for measuring the employer’s liability for a defined return benefit promise. The staff has loosely coined the terms the DC and DB approaches as they are analogous to the accounting for DC and DB plans respectively.

B2 In both cases, defined return promises have two components:

(i) A contribution requirement

(ii) The promised return on those contributions

The DC approach

B3 Under the DC approach:

a. the employer’s liability in respect of the contribution requirement is measured at the sum of any unpaid contributions; and

b. the employer’s liability in respect of the promised return is measured as the fair value of the promised return less any plan assets available to satisfy that liability.

The DB approach

B4 Under the DB approach, the liabilities and assets are measured on a gross basis. The plan assets are measured at fair value, and:

a. the employer’s obligation in respect of the contribution requirement is measured as the accumulated value of the contributions payable plus the promised return accrued on those contributions at the balance sheet date; and

b. the employer's obligation in respect of the guaranteed future returns on the specified contributions payable in respect of current and prior service is measured at fair value.

Application of the two approaches

B5 Consider the following plan (this is the same as 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.

B6 The illustrations below are based on the following assumptions:

a. The contributions payable to date – 100

b. The contributions paid to date - 100

c. The promised return already accrued on the contributions paid - 10

d. The fair value of the guaranteed future returns - 25 (ie the fair value of the guarantee of returns on the equity index over the period to retirement applied to the contributions payable at the balance sheet date).

e. The market value of assets is 130 (the actual return on the assets has been greater than the promised return on contributions)

The DC approach

B7 Under the DC approach, the liability is measured as follows:

Contribution requirement: Nil

Promised return: 10 + 25 - (130 – 100) = 35 - 30

Total net (asset) liability: 5

The DB approach

B8 Under the DB approach, the liability is measured on a gross basis and would be derived as follows:

Contribution requirement: (100 + 10) = 110

Promised return– 25

Total gross liability - 135

Market value of assets – 130

Total net (asset) liability - 5

APPENDIX C

SUMMARY OF DECISIONS / STAFF RECOMMENDATIONS TO DATE

Definitions

44. *Post Employment benefits* are employee benefits (other than termination benefits) which are payable after the completion of employment. These benefits are comprised of *defined benefit, defined contribution* and *defined return* benefit promises.

    [Similar modifications would be required for other long-term benefits]

    i. A *defined contribution* benefit promise obliges the employer to pay contributions to a separate entity (a fund). Payment by the employer of the specified contributions extinguishes the obligation.

       These benefit promises are accounted for in accordance with current IAS 19 requirements for defined contribution plans.

    ii. 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 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 defined return on the specified contributions. That defined return is linked to the change in an asset or index.

       The employer's liability for the contribution requirement is measured as the sum of the accumulated unpaid contributions. The employer's liability for the promised return component is measured as the fair value of the promised return less any plan assets available to satisfy that liability.

iii. 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[5].

These benefit promises are measured in accordance with the current IAS 19 requirements for defined benefit plans.

Identification of benefit promises

45. Some plans are wholly defined contribution (Example 1), defined return (Example 2) or defined benefit in nature (Example 3).

46. Other plans may consist of any two or more combination of benefit promises. In this case the plan should be separated into defined benefit, defined contribution and defined return promises, where applicable. The benefit promises would be measured independently and then aggregated in order to determine the accounting for the plan as a whole. See Examples 4 – 8.

47. An employer would not be allowed to identify a benefit promise that is not specified and may not establish terms of the benefit promise that are not already clearly present in the terms of the plan

Measurement

48. The employer’s obligation in respect of defined benefit and defined contribution plans will continue to be measured in accordance with the current IAS 19 requirements.

49. The employer’s obligation in respect of defined return promises would be measured as follows:

    - The employer’s obligation in respect of the contribution requirement is measured at the sum of any unpaid contributions

    - The employer’s obligation in respect of the promised return on the contributions would be measured at the fair value of the promised return less the excess, if any, of plan assets available to meet that liability.