

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

**International
Accounting Standards
Board**

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

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: Promises with guaranteed fixed returns compared to salary-related promises (Agenda paper 10B)

Background

1. Paper 10A proposes the following definitions of defined return and defined benefit promises:

- i. 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.

- ii. 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. The objective of this paper is to determine whether:
- (a) benefit promises with guaranteed fixed returns should be classified as defined return; and
 - (b) whether a distinction should be drawn between current salary, career average and other salary-related benefit promises.

Staff recommendation

3. The staff recommends that:
- (i) benefit promises with guaranteed fixed returns are classified as defined return;
 - (ii) current salary and full career average benefit promises are classified as defined return benefit promises;
 - (iii) other salary-related promises, when the benefit earned in previous years is affected by future salary increases, are classified as defined benefit.

Guaranteed fixed returns

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

Plan A 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 guaranteed fixed return on the contributions of 3% per year.

5. The staff agrees that such a promise in principle fits exactly within the definition of defined return. The promise is defined completely by contributions and a

specified return on those contributions. Therefore promises with a guaranteed fixed return should be classified as DR.

6. However, classifying promises of guaranteed 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.

Career average promises

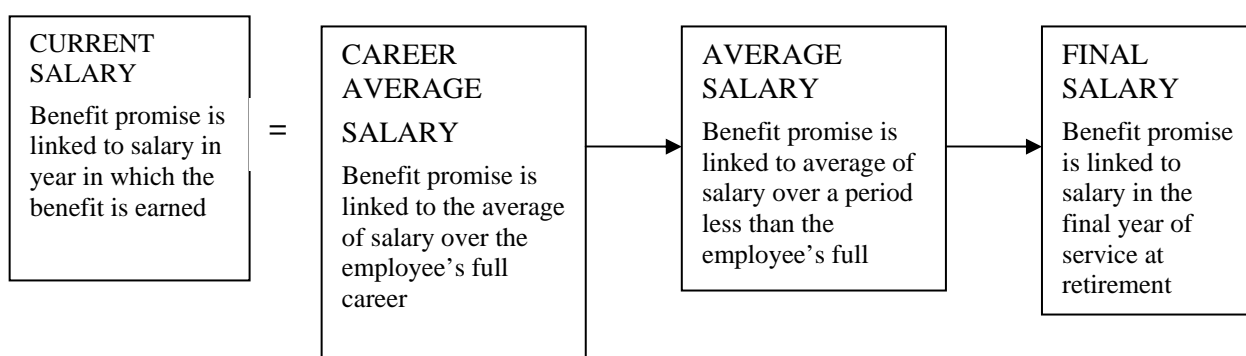
7. A career average promise is one which is linked to the average of the employee's salary over their entire career. These promises are currently treated as defined benefit (in their entirety) under both IAS 19 and SFAS 87. However, as discussed below, some of these promises are exactly the same as defined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

Plan B: 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 guaranteed fixed return of 0% per year.

Plan C: 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.

9. Plan B would be classified as defined return with a contribution requirement of 5% of salary and a guaranteed fixed return of 0%, using the classification in paper 10A. Plan C is a career-average promise..
10. As illustrated in Appendix A, Plan B and Plan C 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, either both promises should be treated as defined return or both promises should be treated as defined benefit.

11. However, career average promises seem very similar to other average salary and final salary promises. Under SFAS 87 and IAS 19 career average promises are regarded as closely linked to final salary promises. So the question is whether treating current salary promises with fixed returns as defined return implies that all salary-related promises are defined return . If so, this would be difficult to reconcile with the concept of Phase I having a limited scope.
12. In order to keep Phase I as a limited scope project, it is necessary to draw a distinction between some type of salary-related promises and other types of salary-related promises.
13. Salary-related benefit promises exist along a continuum as set out below:



14. The staff has investigated 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
- OR treat current salary and career average promises as identical and:
- (b) treat all guaranteed return promises 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.

Distinction based on the benefit formula

15. Some may argue that, in the employee benefit model, the way the benefit is described is key to the classification of that benefit promise. In other words, the benefit formula is paramount. They would argue that the fact that the same benefit is treated in different ways because of the way it is described is just an

unfortunate aspect of the existing employee benefit model, which is not something that we should change in Phase I of the project.

16. 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.
17. 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.

Distinction based on treating guaranteed return promises as defined benefit

18. This approach would treat current salary and career average salary promises with fixed guaranteed returns as defined benefit. So all the plans in the above continuum would be treated as defined benefit. This classification would apply only to promises with guaranteed *fixed* returns. It does not apply 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.
19. This approach would require the proposed definitions of defined return and defined benefit promises to be revised, as follows:
 - (i) ... 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 excluding assets or indices linked to guaranteed fixed returns.

(ii) All other benefit promises are defined benefit. Typically, defined benefit promises change in line with guaranteed fixed returns, service or salary or include demographic risks to the employer while the benefit is in payment.

20. 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.

21. However, this approach makes the definitions more complex to describe and operationalise. 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 guaranteed fixed return promises is changed.

Distinction based on salary risk to the entity

22. 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.

23. The distinction depends on whether or not 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 deemed to be unaffected by future salary increases, and would be classified as DR. If not the benefit for the period is deemed to be affected by future salary increases, and would be classified as DB.

24. For instance, consider promise D:

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.

25. Appendix B shows that it is not possible to express the benefit promise in Promise D 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 C where the benefit promise could be expressed in current salary terms (ie Plan C could be expressed in the same way as Plan B).
26. 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.
27. 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. This aspect of defined benefit accounting will not be changed in Phase I of this project.
28. The advantages of this approach are that it allows identical economic benefit promises (ie current salary and career average promises) to be accounted for in the same way, draws a clear, non-arbitrary line between current salary/carer average promises and other salary-related benefit promises and does not require a change in the definitions proposed.
29. The disadvantages to the approach are that constituents may find it difficult to understand why career average promises are classified differently from other average and final salary promises. As noted above, such promises are treated by SFAS 87 and IAS 19 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.
30. Nonetheless, the staff argues that the advantages of this approach outweigh the disadvantages, and the approach is better than the other two options. Therefore the staff recommends that salary-related promises that can be expressed wholly in terms of contributions based on current salary should be treated as defined

return. Salary-related promises that cannot be so expressed should be classified as defined benefit.

31. The staff also thinks that it would be useful to include a question in the Discussion Paper on how many promises this classification would affect, ie how many promises would be reclassified from existing defined benefit to defined return and whether there would be any practical difficulties in so doing.

Does the Board agree that the Discussion Paper should specify that salary-related promises that can be wholly expressed in terms of contributions based on current salary should be treated as defined return?

Does the Board agree that a question should be included in the Discussion Paper on how many promises would be affected and whether there would be any practical difficulties in so doing?

Comparison of Plans B and C

Consider the following promises:

Plan B: 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 guaranteed fixed return of 0% per year.

Plan C: 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 B and C 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 B) is equal to the average benefit multiplied by the number of years (Plan C). Therefore, as shown in the table below, both promises are equivalent.

Year	Salary	Plan B benefit if employee left in this year	Career Average Salary	Plan C benefit if employee left in this year
1	85	$5\% \times 85 = 4$	$= 85$	$5\% \times 85 \times 1 \text{ yr} = 4$
2	105	$5\% \times 105 + 4 = 10$	$= (85 + 105)/2 = 95$	$5\% \times 95 \times 2 \text{ yrs} = 10$
3	110	$5\% \times 110 + 10 = 15$	$= (85 + 105 + 110)/3 = 100$	$5\% \times 100 \times 3 \text{ yrs} = 15$

More generally,

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

Let Sal(t) be the salary at time t

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

$$= 5\% \times \text{Sal}(t) + 5\% \times \text{Sal}(t-1) + 5\% \times \text{Sal}(t-2) + \dots + 5\% \times \text{Sal}(1)$$

$$= 5\% \times t \times [\text{Sal}(t) + \text{Sal}(t-1) + \text{Sal}(t-2) + \dots + \text{Sal}(1)]$$

$$= 5\% \times t \times [\text{Sal}(t) + \text{Sal}(t-1) + \text{Sal}(t-2) + \dots + \text{Sal}(1)] / t$$

$$= 5\% \times \text{service} \times \text{career average of salary}$$

$$= \text{the benefit in plan C}$$

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

Benefit promise earned in Plan D

Consider the following promise:

Plan D: 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 D benefit if employee left in this year	Plan D benefit earned in each prior year if employee left in this year
1	85	= 85	$5\% \times 85 \times 1 \text{ yr} = 4$	Year 1 - $5\% \times 85 = 4$
2	105	$= (85 + 105)/2 = 95$	$5\% \times 95 \times 2 \text{ yrs} = 10$	Year 1 - $5\% \times 85 + 5\% \times (95-85)$ Year 2 - $5\% \times 95$
3	110	$= (105 + 110)/2 = 108$	$5\% \times 108 \times 3 \text{ yrs} = 16$	Year 1 - $5\% \times 85 + 5\% \times (95-85) + 5\% \times (108-95)$ Year 2 - $5\% \times 95 + 5\% \times (108-95)$ Year 3 - $5\% \times 108$