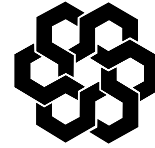

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

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:	**16 October 2007, London**
Project:	**IAS 19 *Employee Benefits***
Subject:	**Classification of benefit promises measurement of benefits in the payout and deferment phases (Agenda paper 4)**

Introduction

1. At the September meeting the Board noted that post-employment benefit promises have three phases. The three phase are:

(a) An accumulation phase during which the employee renders service in exchange for the promise of remuneration in the future. This phase ends when the employee ceases employment.

(b) A deferment phase, which occurs after the employee has completed employment but before the benefit payment has started (eg during a pension deferment period or a sickness waiting period).

(c) A payout phase during which the employer's liability to the employee for previously deferred remuneration is settled.

2. The two key questions raised were:

(a) Which phase or phases should determine the classification of

the benefit promise; and

(b) How should the benefit promise in each phase be measured.

3. The Board discussed whether the definitions of benefit promises should refer to the accumulation phase only. Some Board members noted that the effect of longevity risk could be significant and asked the staff to consider the effect this could have on the classification of benefit promises.

4. The Board also discussed how benefit promises in each phase should be measured and noted that, since the accounting for post-employment benefit promises uses a mixed measurement model, there is a choice between:

   - Measuring all benefit promises in the payout or deferred payout phase using the methodology currently required by IAS 19 regardless of whether they were accumulated as DR[1] or DB promises. In this case, anomalous gains and losses may arise on retirement when an employee with a DR benefit promise retires; OR

   - Measuring all benefit promises in the payout or deferred payout phase using the same measurement attribute applied in the accumulation phase. In this case, the same obligation to pay a given pension amount would be measured differently in the payout phase, depending on whether it was accumulated as a DR or DB promise.

5. The staff notes that the Board has already made decisions about the classification and measurement of the benefit promise in the accumulation phase. This paper sets out some further consideration of the classification of benefit promises and the measurement of promises in the deferred and payout phases.

[1] At the September meeting, the Board asked the staff to put forward alternative descriptions for the types of promises that we have so far called defined return promises. The staff is working on this, but in this paper we continue to use the term defined return.

Staff recommendation

6. The staff recommends:

(a) The definitions of benefit promises should refer to the accumulation phase only. In particular, longevity risk does not affect the classification.

(b) The liability for a benefit promise should be measured according to its definition whether the employee is in the accumulation, deferment or payout period.

Classification of benefit promises

7. The proposed definitions for defined return and defined benefit promises are :

(a) A defined return promise is a post-employment benefit promise in which the benefit at retirement can be expressed as the accumulation of:

(b) (a) actual or notional contributions for one or more periods of service that can be expressed independently of the salary relating to service after the end of that period; and

(c) (b) any return on the actual or notional contributions is a guaranteed return that is linked to the change in the value of an asset or group of assets or the change in value of an index.

(d) A defined benefit promise is a post-employment benefit promise that is not a defined return promise.

8. At the last Board meeting, some Board members questioned whether longevity risk should imply that a benefit promise is DB. The staff has explored the implications of such an approach and concluded that this would not help the Board's purpose, in Phase I, to achieve a significant improvement to the accounting for the 'troublesome' benefit promises in IAS 19.

9. The following four examples of benefit promises are very similar to each other. However, as we will explain, if the classification of a benefit promise is made dependent on longevity risk the plans would be classified and accounted for differently.

Promise A The employer promises to pay contributions of 5% of the employee's current salary into a fund for each year of service. The promised return is the return on a specified equity index. The benefit is paid as a lump sum equal to the accumulated contributions and promised returns at retirement.

Promise B The employer promises to pay contributions of 5% of the employee's current salary into a fund for each year of service. The promised return is the return on a specified equity index. The benefit is paid as an annual pension income benefit equal to the accumulated contributions and promised returns at retirement converted to a pension at market annuity rates at retirement. The annuity will be purchased from an insurance company at retirement date.

Promise C The employer promises to pay contributions of 5% of the employee's current salary into a fund for each year of service. The promised return is the return on a specified equity index. The benefit is paid as an annual pension income benefit equal to the accumulated contributions and promised returns at retirement converted to a pension at market annuity rates at retirement. The annual annuity payments will be provided from the fund.

Promise D The employer promises to pay contributions of 5% of the employee's current salary into a fund for each year of service. The promised return is the return on a specified equity index. The benefit is paid as an annual pension income benefit equal to the accumulated contributions and promised returns at retirement converted to a pension at a guaranteed rate such that each CU12 of the lump sum will be converted to CU1 of pension income). The annual annuity payments will be provided from the fund.

10. A summary of the existence of any longevity risk in each phase of the four benefit promises is summarised in the table below. The effect of this on the classification of the promise is explained further in the following paragraphs.

Promise	Longevity risk in Accumulation Phase?	Longevity risk in Payout Phase?
A	No	No
B	No	No
C	No	Yes
D	Yes	Yes

11. For Promise A, the employer does not have longevity risk in either the accumulation or payout phases. Therefore, Promise A would be classified as DR regardless of whether the Board decides longevity risk implies that a promise is DB.

12. Also, for Promise B, the employer does not have longevity risk in either the accumulation or payout phases. Longevity risk exists in Promise B to the extent that the price of the annuity to be purchased will be affected by expectations about longevity. However, the employer does not retain any of this risk because it has promised to provide only the amount of the pension that can be purchased at market annuity rates using the accumulated lump sum at retirement. If employees are expected to live longer the amount of the pension to be provided will decrease to compensate and vice versa. Therefore, Promise B would be classified as DR regardless of whether the Board decides longevity risk implies that a promise is DB.

13. During the accumulation phase of Promise C, the employer does not have longevity risk. Longevity risk exists in Promise C because the cost to the employer of the pension to be provided will be affected by expectations about longevity. However, during the accumulation phase, the employer has promised to provide only the amount of the pension that can be acquired from the accumulated lump sum at market annuity rates. If employees are expected to live longer, the amount of the pension to be provided will decrease to compensate and vice versa. In fact, during the accumulation phase, Promise C

is the same as Promise B. In each case, the lump sum is accumulated in the same way and the expected amount of the pension income is calculated by reference to market annuity rates.

14. However, in the payout phase of promise C, the employer bears the longevity risk for the pension payments. Therefore, *if a distinction is made depending on whether the entity bears longevity risk*, Promise C would be classified as DB in the payout phase. From the discussion at the last Board meeting, the staff understands that some Board members thought that perhaps that risk in the payout phase should also affect the classification in the accumulation phase. If that were the case, Promise C would be classified as DB throughout its term.

15. Promise D is different from the other three promises because the employer has longevity risk in both the accumulation and payout phases. If employees are expected to live longer, the amount of the pension to be provided will not decrease to compensate because the annuity rate is fixed. Therefore, the cost of the benefit to the employer, in each phase, is affected by changes in expectations about longevity. *If a distinction is made depending on whether the entity bears longevity risk,* Promise D would be classified as DB and the liability during the accumulation phase would be measured using the projected unit credit (PUC) method.

16. The classification in the accumulation and payout phases for each of the four benefit promises if longevity risk is deemed to be relevant compared with the classification with reference to the nature of the benefit promise in the accumulation phase is summarised in the table below.

Promise	Longevity risk in Accumulation Phase?	Longevity risk in Payout Phase?	Classification if longevity risk is relevant?	Classification with reference to the accumulation phase?
A	No	No	**DR**	**DR**
B	No	No	**DR**	**DR**
C	No	Yes	**DB**	**DR**
D	Yes	Yes	**DB**	**DR**

17. The main difficulty with classifying Promise C and Promise D as DB is that the PUC method is considered to be inappropriate for benefit promises that accumulate as a contribution amount with a promised return linked to assets or indices. Therefore, if Promises C and D are classified as DB, the key benefit of making the accounting changes in Phase I, ie to improve the accounting for such benefit promises, would be lost.

18. The staff does not think that the way in which the benefit promise is settled (and therefore whether or not there is longevity risk) should determine the classification of that promise. The effect of any longevity risk should instead be included in the *measurement* of the employer's liability.

19. More generally, the purpose of the revised classification of benefit promises in Phase I is to address the measurement problem for benefits that include a promised return linked to changes in assets or indices or that provides a 'higher of' alternative. Longevity risk is not relevant to that problem. Overall, therefore, the staff thinks that longevity risk should not be a factor in the classification of benefit promises.

20. The important factor is that, during the accumulation phase, the nature of the employer's liability in a DR and a DB promise are very different. In one case the risk includes a risk in respect of financial assets. In the other, it is in respect of future salary increases (typically). Therefore, the staff recommends that the

distinction between benefit promises should be based on the nature of the benefit promise in the accumulation phase only.

21. The staff acknowledges that this is a pragmatic rather than a conceptual approach. However the staff thinks that this is the best way of achieving a targeted improvement in the accounting for post-employment benefit promises as part of Phase I.

Does the Board agree that the distinction between benefit promises should be based on the nature of the benefit promise in the accumulation phase only and that classification should not be affected by longevity risk?

Measurement of benefit promises during payout and deferment

22. The staff and the Board previously noted that, since the accounting for post-employment benefit promises uses a mixed measurement model, measuring benefits in the payout and deferred periods consistently with the measurement approach used in the accumulation period would mean that the same obligation would be measured differently. For example:

    Promise E is a defined return promise in which the contributions plus the investment returns are converted to an annuity at a guaranteed rate. The employer retains the obligation to make the annual payments to the employee. In this example, based on the accumulated contributions and returns at retirement, the employee is entitled to receive CU100 per annum after retirement.

    Promise F is a defined benefit promise in which the employee is entitled to annual payments of 50% of his final salary after retirement. The employee's final salary is CU200. Thus, the employee is entitled to receive CU100 per annum after retirement.

23. In both promises, the employer's obligation is to pay CU100 per annum every year until the employee dies. If the employees have the same life expectancy, one might expect the payout liabilities for the two employees to be exactly the same. However, if the post-retirement liability is measured in accordance with the way the benefit accumulates, at the end of the accumulation phase, the

employer would have two different liabilities. Ignoring demographic assumptions, the DR liability would broadly be 100 plus a market margin per year discounted at a risk-free rate and the DB liability would be 100 a year discounted at the IAS 19 discount rate.

24. On balance, the Board seemed to prefer an approach that results in appropriate and consistent accounting for the benefit promises for which the accounting is being changed. This means the Board preferred to use the same measurement approach for the liability for DR promises in the accumulation, deferred and payout phases. Consistency with the accounting for DB promises would be left to phase II. The staff agrees that this is a workable approach for phase I.

The liability for a benefit promise should be measured according to its classification whether the employee is in the accumulation, deferment or payout period. Does the Board agree with this?