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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **19 September 2007, London**

Project: **IAS 19 *Employee Benefits***

Subject: **Cash balance and similar plans – Definitions of benefit promises (Agenda paper 6A)**

Background

1. At the July meeting the staff proposed definitions for three categories of benefit promises - *defined benefit, defined contribution* and *defined return*. The Board suggested some changes to the proposed definitions. In particular, the Board noted that DC promises are a subset of DR promises and asked whether these two categories could be combined.

2. Further, one Board member questioned the rationale for using the DB category as the residual category instead of the DR category.

3. This paper sets out revised definitions and the staff recommendations in respect of the issues raised.

Staff recommendation

4. The staff recommends the following definitions:

i. *Post-employment benefits* are formal or informal arrangements under which an entity is obliged to provide *employee benefits* (other than *termination benefits*) that are payable after the completion of employment.

ii. A *defined return* promise is a *post-employment benefit* accumulated through a contribution amount which, for any given period, can be expressed independently of the salary that will be earned after the end of that period.

   For some *defined return* promises the entity may have an obligation for the promised return on the contribution amount. The promised return is a guaranteed fixed return, the change in the value of an asset, or group of assets, the change in value of an index, or any combination of these.

iii. A *defined benefit* promise is a post-employment benefit that is not *defined return*.

iv. A benefit promise that provides the higher of a DB and a DR promise is a DB promise with a “higher of” alternative.

5. A summary of the application of the definitions is set out in appendix A.

Clarification of the definition of defined return promises

6. The staff has revised the definition of defined return promises to clarify the following issues:

   (i) The proposed definitions classify post-employment benefit promises by reference to the way the benefit is accumulated. The characteristics of the way in which the liability for post-employment benefit promises is settled do not affect the definitions. This is discussed further in Paper 6B.

   (ii) The contribution requirement must be independent of future salary increases. The Board decided previously that the promises within the scope of this aspect of Phase 1 would be those that are problematic to account for in accordance with IAS 19 and which do not expose the employer to salary risk. Therefore the Board distinguished between benefit promises that can be expressed independently of future salary increases (defined return promises) and other benefit promises. This implies that benefit promises based on any combination of current and past salaries are defined return.

For example a promise may be described as providing contributions of 10% of the average of the last two years' salary for each year of service. This benefit promise is independent of future salary increases and so should also be defined return.

(iii) The same benefit promise may be described as current salary (independent of future salaries) or career average (dependent on future salaries). A benefit promise should not have its classification based on the way in which it is described. Therefore the focus should be on whether or not the benefit promise *can be expressed* independently of future salaries.

(iv) Benefit promises of fixed amounts to be paid at a future date are defined return. Such a promise is the same as a defined return promise with a contribution amount that is independent of future salary increases and a guaranteed fixed return of 0%.

(v) The employer's liability for any negative returns on contributions that have already been paid is included in the promised return component.

(vi) Some benefit promises may include a combination of any two or more types of promised returns. Benefit promises based on a combination of two or more types of promised return (eg an equity index plus 50 basis points or the higher of the return on assets in the plan and a guaranteed fixed return of 0%) are defined return.

7. The following revised definition of a *defined return* promise attempts to address the points raised above.

> A *defined return* promise is a *post-employment benefit* accumulated through a contribution amount which, for any given period, can be expressed independently of the salary that will be earned after the end of that period.
>
> For some *defined return* promises the entity may have an obligation for the promised return on the contribution amount. The promised return is a guaranteed fixed return, the change in the value of an asset, or group of assets, the change in value of an index, or any combination of these.

Does the Board agree the proposed revised definitions of defined return promises?

Contribution penalties

8. At the last meeting, one Board member noted that, in some jurisdictions, an employer may have a liability for a penalty payable to the Government or other body (ie not to the plan or directly to the employee) if contributions due to the plan are paid late. The staff has investigated how such a liability should be accounted for and, in particular, whether it should be included in the recognition of the employer's obligation for the contribution component or the promised return.

9. Under current IFRSs there are two possible ways of accounting for such a liability: either as an obligation under IAS 37 or as an obligation under IAS 19.

10. The staff notes that the IFRIC decided not to give guidance on a similar issue in March 2007 related to special wage taxes on employee benefits.

11. The IFRIC was asked to consider whether taxes related to defined benefits, for example taxes payable on contributions to a defined benefit plan or taxes payable on some other measure of the defined benefit, should be treated as part of the defined benefit obligation.

12. The IFRIC noted that the scope of IAS 19 is not restricted to benefits paid to employees. It includes some costs of employee benefits that are not paid to employees. The IFRIC also noted that a wide variety of taxes on pension costs could exist worldwide, each specific to its own jurisdiction, and it is a matter of judgement whether they are income taxes within the scope of IAS 12, costs of employee benefits within the scope of IAS 19, or other costs within the scope of IAS 37.

13. The staff thinks that this issue is similar to the treatment of penalties due as a result of late contribution payments. Given the variety of arrangements for paying penalties that may be possible, the staff thinks that it should be a matter of judgement whether they are costs of employee benefits within the scope of IAS 19, or other costs within the scope of IAS 37. Therefore the staff does not recommend that specific guidance on the treatment of penalties payable is included in the discussion paper.

Does the Board agree that no further guidance should be given with respect to contribution penalties payable to an external body?

Other issues on the definition of defined return promises:

14. The key remaining issues to be discussed with respect to the definitions of benefit promises are whether DC and DR promises should be combined and whether the residual category should be DB or DR. These are discussed below.

Combining Defined Contribution and Defined Return Promises

15. At the July meeting, the Board asked the staff to consider whether defined return and defined contribution promises should be combined into one category.

16. An example of a defined contribution promise is a s follows:

    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.

    An example of a defined return promise is as follows:

    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.

17. The only difference between the two plans is that, for a DC promise, the entity has no further obligation once the contributions are paid, whereas for a DR promise, the entity has an obligation for a promised return. In other words, DC promises are simply a special case of DR promises.

18. It is sometimes difficult to distinguish between a DC and a DR promise. Some DC promises allow the employer to delay payment of contributions to the plan for a specified period. In this case, the employer will have an obligation for the delayed contributions and, possibly, the promised return on those contributions. Therefore some promises will be DC for a period of time, then DR if the contributions are late and then DC again once the contributions have been paid.

19. The staff thinks that DC and DR promises should be categorised the same. Otherwise, either benefit promises would change their categorisation depending on when the employer pays the contributions, or an arbitrary rule that sets the period of time within which the contributions must be payable would be required.

20. There are some possible arguments against combining the benefit promises under a single classification. The first is that combining the two promises would represent a change in the accounting for typical DC promises. Currently under IAS 19, the employer's liability for any unpaid contributions in a DC plan is measured at the accumulated value of those unpaid contributions if the contributions are expected to be paid in 12 months or present value using the IAS 19 discount rate otherwise.

21. The staff recommends in Paper 6C that the Board measures the entire liability for a defined return promise at the fair value assuming the benefit promise does not change. If the Board agrees with this, the liability for unpaid contributions in a DC promise would be measured at fair value instead of at present value.

22. However, under the existing definition of a DC plan, the period of time over which any contributions can remain unpaid must be short. Otherwise, the employer bears investment risk and the plan would not be DC. Therefore the change from present value to fair value assuming the benefit promise is unchanged should not create significant differences in practice. Therefore the staff thinks that the Board should combine the two benefit promises.

23. Another argument against combining the benefit promises is that the presentation and disclosure requirements for a DC promise would be increased. Currently, the employer is not required to disclose information about the plan assets and plan liabilities in a DC plan. If the DC promise is accounted for as DR, the employer may be required to disclose more information than previously.

24. The Board has not yet discussed disclosure requirements for DR promises. A fuller discussion of the disclosure requirements for all benefit promises will be discussed after the publication of the Discussion Paper, during the development of an ED. However, given that the DR category is a new category of benefit promises, and the disclosure requirements for formerly DC promises could change, the staff thinks that it would be useful to indicate what the specific

disclosure requirements for DR promises might be. This may also help constituents' and users' understanding of the proposed changes.

25. For some DR promises, the entity has no obligation for the promised return component (the formerly DC promises). The staff thinks that, in order for the information disclosed in the notes to be decision-useful, the entity should only be required to disclose assets and liabilities for which the entity has an obligation because it retains some risk. For the formerly DC promises, the entity has no further obligation once the contributions due have been paid to the plan. Therefore, no balance sheet disclosures are required. For other types of DR promises, the entity is at risk for the promised return and fuller disclosures would be required.

26. If this approach is followed, the staff maintains that any increased disclosure requirements for a pure DC promise would be minimal.

27. Finally, at the recent meeting with the SAC and ARG, the groups urged the IASB to endeavour to reduce the number of benefit categories as far as possible. Including DC promises with DR promises would help to serve this aim.

28. Therefore the staff recommends that the two benefit promises are combined.

Does the Board agree that DC and DR promises should be combined as DR promises?

The residual category

29. The staff notes that there is a residual collection of benefit promises which have not yet been explicitly considered ie those that do not rely only on service or salary (typical DB promises) or fixed increases, indices or assets (DR promises). The question is whether they should remain classified as DB or whether they should be included in DR promises.

30. The staff notes that the scope of Phase I is limited to the work that can be done in a four year period and any changes should be limited to the 'troublesome' plans that are clearly identified. This avoids the possibility of inadvertently changing the measurement requirements for plans of which the staff is unaware.

31. Also the Board has not addressed the accounting treatment of post-retirement medical plans in phase I of this project. Most post-retirement medical plans have no salary risk and so would be DR. Therefore, the employer would be required to measure its liability for such plans at fair value.

32. The staff thinks that there are a number of issues to be considered with respect to post-retirement medical plans and to include them in the DR category without further consideration of the nature of these promises would be premature. Further, the Board had already decided to consider the treatment of these types of promises in Phase II.

33. Overall therefore, the staff recommends that the residual category would be DB promises rather than DR promises.

Does the Board agree that the residual category should be DR promises?

APPENDIX A

The following table sets out a brief comparison of the proposed changes and current IAS 19 requirements.

	Current IAS 19 Approach	**Proposed Changes**
Categorisation of plans	DB or DC only	DB or DR only. All benefit promises that were DC are now DR. Some benefit promises that were DB are now DR.
Definition of DB	Where there is downside risk to the entity.	Residual category. Typically benefit promises that change in line with service and future salary increases.
Definition of DC	Where there is no downside risk to the entity	Now DR. Contribution amount plus promised return.
Option to have the higher of two or more promises	Ignored	Identified as a higher of alternative with the option measured at fair value assuming that the benefit promise does not change.
Measurement of the liability for DB promises	PUC method	PUC method
Measurement of liability for benefits with a promised return on an equity index.	PUC method	Fair value assuming that the benefit promise does not change.

The following table sets out a brief comparison of the application of the proposed changes and current IAS 19 requirements to typical benefit promises.

Description of benefit promise	**Current IAS 19 Approach**	**Proposed Changes**
A lump sum benefit accumulated as follows: Contributions are 8% of salary for each year of service and the return on contributions is equal to the actual return on plan assets. The entity has no further obligation to pay further contributions to the plan, once the defined contributions are paid	DC	DR
A pension equal to 5% of final salary for each year of service	DB	DB
A fixed amount of CU 10,000 payable at retirement.	DB	DR
A lump sum benefit accumulated as follows: Contributions are 8% of salary for each year of service increased at a rate of 4% per year until retirement	DB	DR
A lump sum benefit accumulated as follows: Contributions are 8% of salary for each year of service increased in line with the actual return on plan assets. The guaranteed minimum return per year is 3.25%.	DB	DR
A lump sum equal to 8% of salary for each year of service increased in line with an equity index.	DB	DR
The higher of: a lump sum equal to 8% of salary for each year of service increased in line with the actual return on plan assets; and a lump sum equal to 5% of final salary for each year of service.	DB	DB plus higher of alternative