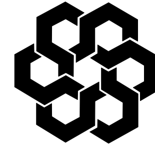

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**19 September 2007, London**
Project:	**IAS 19 *Employee Benefits***
Subject:	**Measurement of benefits in the payout and deferment phases (Agenda paper 6C)**

Introduction

1. In most post-employment benefit arrangements, the employer defers payment of part of the employee's remuneration until after the employee retires. Thus, the promises made to employees could be viewed as having three distinct phases:

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

2. In Agenda Paper 6A, the staff proposes definitions of benefit promises. These definitions refer to the accumulation phase only. The question remains whether this is appropriate and, if this is the case, how benefits in payment and benefits during the deferment period should be accounted for.

Staff recommendation

3. The staff recommends:

The definitions of benefit promises should refer to the accumulation phase only. The liability for all benefits in payment or benefits in the deferment period should be measured at its expected present value using the IAS 19 discount rate and making allowances as appropriate for other factors such as mortality.

Definitions of benefit promises and the three phases

4. It is arguable that the nature of a benefit promise changes during each of the three phases and so the benefit promise should be categorised according to the nature of the promise in the phase that the employee is in. However, if different measurement methods are used for the different types of promises this could lead to anomalous gains and losses arising each time the employee enters a new phase.

5. For example, consider a plan where the promise is DB in the accumulation phase, DR in the deferment period phase and DB in the payout phase. An employee works for 10 years until 31 December 2002. At 1 January 2003, the employee leaves service and becomes a deferred pensioner until 1 January 2004. On 1 January 2004, the employee retires and benefit payment commences.

6. In this case, the benefit promise would be measured using the PUC method for the first 10 years, at fair value on 1 January 2003 and then using the expected net present value method (ie the same as PUC post-retirement) on 1 January 2004. Each time the measurement method changes, significant gains and losses

could arise even though there is no significant change in the nature of the employer’s liability.

7. The staff argues that the distinction between benefit promises should be based on the nature of the benefit promise in the accumulation phase only. This is for the following reasons.

8. 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 is in respect of financial assets. In the other, it is in respect of future salary increases (typically).

9. However, once the employee has ceased employment, the employer’s liability ceases to depend on the way in which that benefit was accumulated. A pension of 1,000 payable in annual instalments each year is the same obligation whether it was accumulated as a percentage of salary, as contributions plus the return on an equity index or as a fixed amount with inflationary increases in the deferment phase.

10. The employer’s liability, once the employee has ceased employment, is just the same as any other financial liability. There is therefore no basis for making a distinction between benefit promises in the payout and deferment phases. In the next section, the staff argues that all benefit promises, once the employee has ceased employment, should be accounted for in the same way.

Measurement of benefit promises during payout and deferment

11. The staff argues that, for pragmatic reasons, all benefits in the payout or deferred payout phase should be measured in the same way. This is because treating some benefits in the payout phase as DR and some as DB would lead to anomalous results.

12. During the payout phase, the employer settles its liability to the employee. It may do this in one of the following ways:

Payment of a lump sum to the employee.
Purchase of an annuity (eg from an insurance company) that settles the employer’s liability to make annual payments every year until the employee’s death.

Annual payments every year until the employee's death (an annuity):
(a) based on market annuity rates at the date of the employee's retirement; or (b) based on an annuity rate other than market rate at the date of the employee's retirement.

13. The staff notes that the same obligation at retirement could arise from different methods of accumulation. For example:

Plan A is a defined return plan 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.

Plan B is a defined benefit plan 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.

14. In both Plan A and Plan B, 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 recognised the following liability:

in Plan A at the fair value, assuming the benefits do not change,
in Plan B at the expected net present value using the IAS 19 discount rate and making allowances as appropriate for other factors such as mortality.

15. Unless the Board requires that defined return promises in payment are also measured using the projected unit credit method, the liability recognised by the employer at retirement may be different for plan A and plan B. This does not seem desirable.

16. A similar argument applies for benefit promises in the deferred payout phase. In particular a benefit promise could be measured using the PUC method in the accumulation phase (DB), measured at fair value in the deferment phase (DR) and using the expected present value method in the payout phase.

17. The staff notes that it is outside the scope of phase one to measure the liability in the payout phase of a DB promise using anything other than the expected net present value at the IAS 19 discount rate and making allowances as appropriate for other factors such as mortality. The staff therefore recommends that benefits in the pay out phase or deferred payout phase for a DR promise should be measured in the same way. This is a pragmatic rather than a conceptual approach to accomodate the constraints of Phase I.

18. The above conclusion implies that defined return promises would be measured:

> at fair value, assuming the benefit promise does not change, in the accumulation phase and,
>
> for the deferment and payout phases at the expected net present value using the IAS 19 discount rate and making allowances as appropriate for other factors such as mortality.
>
> This approach could lead to a gain or loss arising on the plan liabilities on retirement because of the change in measurement attribute.

19. The staff acknowledges that using different measurement attributes for the same benefit promise over time is not ideal. But the staff argues that the recommendation is the best possible, given the limited scope and short time frame available for phase one.

Therefore, the staff recommends that the liability for all benefits in payment or benefits in the deferment period and payout period should be measured at the expected net present value using the IAS 19 discount rate and making allowances as appropriate for other factors such as mortality. Does the Board agree the staff recommendation?