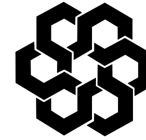

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International Accounting Standards Board

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: **March 2009, London**

Project: **Post-employment Benefits**

Subject: **Additional issues raised in comment letters - Attribution where benefits are back end loaded (Agenda paper 8F)**

Purpose of this paper and staff recommendation

1. IAS 19 requires that the benefit in defined benefit plans is attributed to periods of service in accordance with the benefit formula, unless the benefit formula would result in a materially higher level of benefit allocated to future years. In that case the benefit is allocated on a straight line basis (paragraph 67 of IAS 19).

2. This paper asks the Board to decide whether expected future salary increases should be taken into account in determining whether a benefit formula expressed in terms of current salary allocates a materially higher level of benefit in later years.

3. **In paragraph 21, the staff recommends that to be consistent with other aspects of IAS 19, expected future salary increases should be included in the assessment.**

The Issue

4. The issue is best illustrated by looking at the attribution of a benefit expressed as a percentage of current salary. For example, consider a benefit equal to 10% of current salary for each year of service with a promised return of 0%, and the salary is expected to increase by 3% per year. When determining if such a benefit is back-end loaded, the issue is whether expected future salary increases should be taken into account. Or explained in another way, assuming that the benefit below is considered back-end loaded when including expected future salary increases, should the attribution be as per the benefit formula or on a straight line basis. The example below is developed further in the staff analysis section.

	Salary	Attributed as per the benefit formula	Attributed on a straight line basis
Year 1	40,000	4,000	4,247
Year 2	41,200	4,120	4,247
Year 3	42,436	4,244	4,247
Year 4	43,709	4,371	4,247
Year 5	45,020	4,502	4,247
		21,237	21,237

Consideration of attribution in the discussion paper

5. The Discussion Paper considered the allocation of benefits only in relation to contribution based promises. The Board tentatively decided that an entity should always allocate the contribution component of a contribution based promise to periods of service in line with the benefit formula, even when the benefit formula specifies a materially higher level of contributions in later years (see paragraphs 6.8 to 6.9 of the discussion paper). Therefore, the question of whether expected increases in salary should be taken into account in such an assessment also falls away.

6. However, the issue applies more broadly than just contribution-based promises. And it will be some time before any proposals on contribution-based promises are finalised.

7. Many comment letters on the Discussion Paper raised the issue as something that the Board should address quickly. Those letters indicate that there continue to be differing views in practice. For example:

(a) CL87 maintained that the requirements of paragraph 67 should only apply when the benefit formula alone attributes higher benefits to later periods of service.

(b) CL88 stated that expected future salary increase should be included in any assessment.

Feedback from the Employee Benefits Working Group

8. At its January meeting, the Employee Benefits Working Group was asked for their views on this issue. Most members did not support including future salary increases in the assessment of whether the benefit formula attributes a materially higher level. Some members thought that including future salaries when attributing benefits to periods of service was counter-intuitive, although others thought it was consistent with the measurement method. Issues raised by members included the following:

   (a) Including future salaries will lead to an abandonment of the benefit formula. Even a flat benefit formula could be viewed as back end loaded if future salaries are taken into account.

   (b) Including future salaries is a form of smoothing.

   (c) Some members assumed that the requirements in IAS 19 relating to backend loading were for anti-abuse reasons, and did not envisage that they would apply to a 'normal' defined benefit plan. Accordingly, they assumed that future salaries would not be included in determining whether a plan was back end loaded.

Staff Analysis

9. Paragraph 67 of IAS 19 requires the benefits to be attributed according to the benefit formula unless an employee's service in later years will lead to a materially higher level of benefit than in earlier years, in which case the entity should attribute benefit on a straight-line basis.

10. There are two views regarding the above requirements:

   View A: Some argue that, in order to be consistent with the measurement requirements of IAS 19 and to ensure that the same economic benefits are accounted for in the same way regardless of how they are described

in the benefit formula, expected future salary increases must be taken into account when assessing whether the benefit formula attributes higher benefits to later years of service.

View B: Some argue that to reflect the economic circumstances at the balance sheet date, the liability should only reflect the obligations of the entity at that date. The decision to increase salary would be taken in the future and the effect of that decision should be reflected in an increase in the obligation when the decision is made. Proponents of this view believe that the requirements to attribute benefits on a straight line basis should apply only when the benefit formula alone attributes higher benefits to later years of service (for example in the case of a stepped benefit formula).

11. These views are illustrated in the following examples.

Examples

12. Consider how the views above would apply to the following benefits:

Benefit X: Pays a benefit equal to 10% of current salary for each year of service with a promised return of 0%.

Benefit Y: Pays a benefit of 10% of career average salary for each year of service.

13. Based on a salary of CU40,000 that increases by 3% each year and assuming the benefits vest immediately for both, the benefits allocated to each year of service in accordance with the benefit formula would be as follows:

		Benefit X		**Benefit Y**	
	Salary	**Attributed per year**	**Cumulative attribution**	**Attributed per year**	**Cumulative attribution**
Year 1	40,000	4,000	4,000	4,247	4,247
Year 2	41,200	4,120	8,120	4,247	8,495
Year 3	42,436	4,244	12,364	4,247	12,742
Year 4	43,709	4,371	16,735	4,247	16,989
Year 5	45,020	4,502	21,237	4,247	21,237

14. In economic terms the promises under the two benefits are identical. This can be seen in the vested benefits below. For example, if the employee decides to leave at the end of year 2, their benefit would be equal under both (i.e. CU8,120).

	Salary		Benefit X Vested	Benefit Y Vested
	Actual	Average		
Year 1	40,000	40,000	4,000	4,000
Year 2	41,200	40,600	8,120	8,120
Year 3	42,436	41,212	12,364	12,364
Year 4	43,709	41,836	16,735	16,735
Year 5	45,020	42,473	21,237	21,237

15. Under View A, the amount attributed each year would be equal for both benefits, i.e. as per the attributed per year column of Benefit Y. This is because if expected future salary increases are taken into account, the benefit formula for Benefit X attributes higher levels of benefit to later years. So applying paragraph 67 of IAS 19, the benefit would be recognised on a straight-line basis. Under View B, the amounts attributed would be different for each benefit, even though, economically the benefits are the same. The views diverge based on how the benefit formula is expressed, that is, whether the benefit formula requires some expectation of future salaries.

16. If the expected salary increases are less than the rate of return, the benefit formula will attribute higher benefits to earlier years of service (i.e. front end loaded). The significance of the effect will depend on the difference between the expected salary increases and the rate of return on the contributions. If the two are close, the attribution given by the benefit formula may not be materially different from a straight-line attribution.

17. Conceptually, the recognition (i.e. allocation) of benefits should be based on the liability that exists at the balance sheet date. This is straightforward for benefits that vest in the same period as they are granted. It is less easy for unvested benefits because it is less clear exactly what the liability is that exists at the balance sheet date. Any allocation that reflects expected future salaries will include an unvested element relating to those future salaries.

18. Paragraph 69 of IAS 19 justifies the recognition of unvested benefits as follows:

> Employee service gives rise to an obligation under a defined benefit plan even if the benefits are conditional on future employment (in other words they are not vested). Employee service before the vesting date gives rise to a constructive obligation because, at each successive balance sheet date, the amount that an employee will have to render before becoming entitled to that benefit is reduced.

19. The staff believes that the constructive obligation that arises from unvested benefits arises from the past event of the employees' service during the period. The question that arises in relation to expected future salaries is whether those future salary increases should be regarded as an expected future re-pricing of the obligation that exists at the balance sheet date or as new events that give rise to additional obligations only when the salary increases occur.

20. The staff believes that IAS 19 is silent on the question of expected future salaries in relation to allocation (ie recognition). However, to combine an approach that reflects future salaries in the *measurement* of the obligation that exists at the balance sheet date with an approach that does not reflect future salaries in the determination of what obligation should be *recognised* at the end of the period leads to problems. In particular, it places heavy emphasis on the wording of the benefit formula.

Staff Recommendation

21. In the staff's view, the Board should clarify IAS 19 in accordance with View A for the following reasons:

    (a) benefits that are economically the same should be measured equally regardless how they are described in the benefit formula.

    (b) the counter-argument that the liability should only reflect the obligations of the entity at the balance sheet date relate equally to recognition (attribution) and to the measurement of the defined benefit obligation. Measurement is not within the scope of this project. Given that IAS 19 requires that expected future salary increases are included in the measurement of the defined benefit obligation, so must the attribution.

22. **Therefore the staff recommends the Board amends IAS 19 to clarify that expected future salary increases should be included in the assessment of whether a benefit formula attributes a materially higher level of benefit to future years.**

APPENDIX

The issue above has been considered by both the IFRIC and EITF previously. The following is a summary of these considerations.

Consideration of attribution in draft IFRIC interpretation D9

1. Related issues have been raised with the IFRIC a number of times over recent years. In the deliberations that led to D9 *Employee Benefits with a Promised Return on Contributions or Notional Contributions,* the IFRIC concluded that expected future salary increases should be included in the assessment of whether the benefits are higher in later years of service, as follows:

    > BC11 The IFRIC noted that IAS 19 requires the measurement of plan liabilities to take into account expected future salaries. The IFRIC agreed that this requirement implies that the assessment required in paragraph 67 of IAS 19 of whether higher levels of benefit are attributed to later years of service should also take into account expected future salaries. Otherwise, different allocations could be required for the same benefits depending on how they are expressed in terms of a benefit formula.

2. It reflected its conclusion in paragraph IE4 of the illustrative examples to D9 and in the basis of conclusions.

3. D9 was never finalised because the Board project started to consider contribution-based promises. However, there was considerable opposition to this aspect of D9 in the comment letters.

4. Some respondents stated that the IFRIC's implicit conclusion that expected future salary increases lead to non-level benefits is a significant change in practice and one with implications beyond the cash balance plans discussed in D9. These respondents asserted that the approach in D9 was not how the paragraph 67 requirement had been intended to apply, and that the benefit should not be considered to be back-end loaded solely by the effect of expected future salary increases.

5. Some respondents acknowledged the relationship between measurement and attribution illustrated in paragraph IE4 of D9. However they argue that other factors should be taken in to account, such as whether the plans are 'pay-related'.

6. Finally, other respondents agreed with IFRIC's implicit conclusion, noting the relationship with the projected unit credit method used to value the obligation.

Consideration of attribution in EITF 03-4

7. The EITF considered the accounting for cash balance plans under US GAAP, including the question of the allocation of benefits to periods of service. It has concluded that the benefits should be allocated under a 'traditional unit credit' method. This method does not take into account expected future salaries. Rather, it allocates the benefits based on current salaries. The staff understands that the EITF came to this conclusion on the grounds that the plan was not pay-related. The relevant issues summary argues:

> "The projected unit credit methods all project both pay and service and result in an averaging of accrual rates over the employees' careers. Those approaches are neither faithful to the nature of the contract nor the terms of the plans and result in an arbitrary assignment of costs from one period to another without any basis. The basis of the exchange—the contract or the plan—should govern the accounting; the traditional unit credit method best reflects the economic characteristics of the exchange. In a cash balance arrangement, neither future pay increases nor future pay credits impact the current year's accrual."