Project: **Post-employment benefits**

Topic: **Identification of back end loaded DB plans**

Objective

1. The objective of this paper is to provide the Board with staff analysis of the comments of respondents to the exposure draft *Defined Benefit Plans* (the ED) and staff recommendation thereon, in relation to establishing whether expected future salary increases should be considered in identifying back end loaded defined benefit plans.
2. The staff recommends that the Board confirm the proposal of the ED to consider expected future salary increases in determining whether a benefit formula allocates a materially higher level of benefit in later years.
3. This paper includes:
   (a) Background
   (b) Overview of comments received on the ED
   (c) Staff analysis
   (d) Staff recommendation

Background

4. Paragraph 67 of the current IAS 19 states that an entity should attribute defined benefits to periods for accounting purposes as follows [emphasis added]:

> In determining the present value of its defined benefit obligations and the related current service cost and, where applicable, past service cost, an entity shall attribute benefit to periods of service under the plan's benefit formula. However, **if an employee's service in later years will lead to a materially higher level of benefit than in earlier years, an entity shall attribute benefit on a straight-line basis** from:
>
> (a) the date when service by the employee first leads to benefits under the plan (whether or not the benefits are conditional on further service); until
>
> (b) the date when further service by the employee will lead to no material amount of further benefits under the plan, other than from further salary increases.

5. However, paragraph 67 of the current IAS 19 does not articulate what factors should be taken into account in determining whether a benefit formula allocates a materially higher level of benefit in later years, in particular whether expected future salary increases should be considered or not. Many constituents have questioned how the paragraph should be interpreted.

6. The interpretation of paragraph 67 of IAS 19 may be particularly problematic for a defined benefit plan in which the entity promises to provide a benefit on the basis of a percentage of current salary for each year of service (a current salary plan). For such a plan, it is not clear whether future salary increases should be taken into account in determining whether the benefit formula attributes materially higher benefits to later years.

7. In response, the ED proposed to complement that paragraph by adding paragraph 71A that states:

> In determining whether an employee's service in later years will lead to a materially higher level of benefit than in earlier years (see paragraph 67), an entity shall consider estimates of all factors that affect the level of benefits, including expected future increases in salaries, and its best estimate of benefits that are contingent on performance targets.

8. The basis for the proposal was also provided in paragraphs BC87-BC90 of the ED:

> BC87 Paragraph 67 of IAS 19 requires an entity to attribute benefit on a straight-line basis if an employee's service in

later years will lead to a materially higher level of benefit than in earlier years. Some respondents stated that it is unclear how this requirement applies to future salary increases.

BC88 Some believe that expected future salary increases are not included in determining whether a benefit formula expressed in terms of current salary allocates a materially higher level of benefit in later years. Applying this view, in a current salary plan, an employee's service in later years does not lead to a higher level of benefit than in earlier years because in both cases the benefit is expressed as a constant proportion of current salary.

BC89 However, if expected future salary increases are not included in determining whether a benefit formula expressed in terms of current salary allocates a materially higher level of benefit in later years, there would be different attribution requirements for career average salary benefits and current salary benefits. Such benefits could be the same economically. In the Board's view, benefits that are economically the same should be measured similarly regardless of how the benefit formula describes them.

BC90 Therefore, the exposure draft proposes that expected future salary increases should be included in determining whether a benefit formula expressed in terms of current salary allocates a materially higher level of benefit in later years.

Overview of comments received on the ED

9. Most respondents supported the proposed clarification for the reasons set out in the Basis for Conclusions.

Disagreement with the ED

10. Some disagreed with the proposal to consider expected future salary increases in determining whether a benefit formula allocates a materially higher level of benefit in later years for the reason that in such defined benefit plans as described in paragraph 6:

(a) service in neither previous nor subsequent period changes the benefit increment earned in a specific year; and

(b) the fact that the entity compensates later periods of service at higher levels is an intrinsic part of the plans and there is no reason for smoothing cost over all periods of service - they are not intended to compensate for overall services on a straight-line basis.

Deferral of the issue to the next stage

11. Some suggested that the issue should not be addressed at this stage, because it is closely related to a fundamental review of the accounting for contribution based promises that the Board had decided to carry out at the next stage. They made a point by taking the following comparative examples:

    (a) A defined contribution plan – The entity promises its employee to contribute 5% of current salary for each year of service to a separate fund. The cost of this benefit would not be projected and prorated to reflect that the employer's costs are expected to be higher in later years due to expected future salary growth because the plan is not a defined benefit plan.

    (b) A cash balance plan - The entity promises its employee to credit the employees with 5% of current salary for each year of service and also interest thereon calculated at the rate equal to the return on a tradable, quoted market instrument (and where the credited return may be negative if the instrument falls in value). Under the proposal of the ED, this benefit would not be projected and prorated if the expected salary increases are less than the expected level of market return, but it would be projected and prorated if the expected salary increases are greater than the expected level of market return.

12. Comparing those two plans, they argued that if the entity hedges the market risk of the cash balance plan’s assets by investing in the market instrument on which the interest is credited, the risk and benefits of the two plans are the same

economically and it is not appropriate that the accounting treatment should vary depending on the assumed salary increases relative to the expected returns.

13. Therefore, they think that the issue could not be completely solved at this stage because a review of the distinction between defined benefit plans and defined contribution plans is beyond the scope of the project.

Staff analysis

14. The staff notes that the rationale for why expected future salary increases should be considered in determining whether a benefit is back-end loaded has been made clear in paragraph BC89 of the ED.

15. The Board has previously acknowledged that the measurement of defined benefit obligations under IAS 19 is not appropriate for some types of promises, such as contribution-based promises. However, the Board has decided to address the accounting for contribution-based promises in a future project. The objective of the amendment proposed in the ED is to ensure that benefits that are economically the same should be measured similarly regardless of how the benefit formula describes them.

16. The staff also does not agree that the comparative examples in paragraph 11, which was given by the respondents suggesting deferral of the issue to the next stage, should be regarded as the same economically because:

    (a) in the defined contribution plan as described in paragraph 11(a), the entity is *not* obliged to provide any return but contribution for employee on its own account; however

    (b) in the cash balance plan as described in paragraph 11(b), the entity is obliged to provide a specified return in addition to contribution for employee on its own account even if the related market risk is completely hedged.

17. The staff thinks that the comparative examples are not relevant for the Board's purpose and hence they should not affect the validity of the proposal.

Consequently, the staff believes that the issue of identification of back end loaded DB plans is coherently addressed within the ED.

Staff recommendation

18. The staff recommends that the Board confirm the proposal of the ED to consider expected future salary increases in determining whether a benefit formula allocates a materially higher level of benefit in later years.

Question
Does the Board agree with the staff recommendation that the Board confirm the proposal of the ED to consider expected future salary increases in determining whether a benefit formula allocates a materially higher level of benefit in later years?