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DISCUSSION PAPER

Preliminary Views on Amendments to IAS 19 Employee Benefits

Comments to be submitted by 26 September 2008

International Accounting Standards Board®

Discussion Paper

Preliminary Views on Amendments to IAS 19 *Employee Benefits*

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A Classification of benefit promises

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C Comparison of the Board's preliminary views for contribution-based promises with the existing IAS 19 requirements

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Introduction

Reasons for this project

IN1 This discussion paper presents the preliminary views of the International Accounting Standards Board on amendments to IAS 19 *Employee Benefits*.

IN2 Accounting for post-employment benefit promises is an important financial reporting issue. Anecdotal evidence and academic research suggest that many users of financial statements do not fully understand the information that entities provide about post-employment benefit promises. Both users and preparers of financial statements have criticised the accounting requirements for failing to provide high quality, transparent information about post-employment benefit promises. For example, delays in the recognition of gains and losses and an inadequate measurement methodology give rise to misleading figures in the statement of financial position. Also, multiple options for recognising gains and losses and lack of clarity in the definitions lead to poor comparability.

IN3 This project is the Board's response to calls to review the accounting for post-employment benefit promises. These calls largely came from those who commented on the Board's previous proposals to improve IAS 19. In the longer term, the Board intends to work with the US Financial Accounting Standards Board (FASB) towards a common standard on post-employment benefit promises. That project will take many years to complete. The Board therefore thinks that, in the meantime, short-term improvements are needed to provide users with better information about post-employment promises.

IN4 Accordingly, this discussion paper is the first step in the Board's project on the accounting for post-employment benefit promises. This project is limited in scope to the following issues:

(a) the deferred recognition of some gains and losses arising from defined benefit plans.

(b) presentation of defined benefit liabilities.

(c) accounting for benefits that are based on contributions and a promised return.

(d) accounting for benefit promises with a 'higher of' option.

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Main features of this paper

Recognition and presentation of defined benefit liabilities

IN5 The first part of this paper discusses improvements to the accounting for defined benefit promises that eliminate the deferred recognition and smoothing features of IAS 19. These improvements would require all changes in the value of plan assets and in the post-employment benefit obligation to be recognised in the period in which they occur.

IN6 The Board acknowledges that immediate recognition of all changes in defined benefit promises raises the question of how the components of those changes will be presented. This paper discusses possible approaches to presentation and seeks views. When developing an exposure draft, the Board will decide on an approach for presentation in the light of progress in its project on financial statement presentation and comments received on this paper.

Accounting for benefits that are based on a promised return

IN7 IAS 19 does not result in a faithful representation of the liability for some benefit promises that are based on contributions and a promised return on assets. This paper outlines an approach to overcoming this measurement defect that is based on defining a new category of promises—contribution-based promises—and measuring them at fair value assuming the terms of the benefit promise do not change.

IN8 The Board intends to complete this project on post-employment benefit promises in a relatively short time. Therefore, it decided to limit the scope of the changes it would propose so as not to address the measurement of typical final salary defined benefit pension plans.

Accounting for benefit promises with a ‘higher of’ option

IN9 In some cases, an employer promises the higher of more than one specified amount to employees (in other words the promise includes an embedded option or guarantee). Such promises are said to contain a ‘higher of’ option. IAS 19 classifies benefit promises with a ‘higher of’ option as defined benefit plans. However, the measurement approach in IAS 19 for defined benefit promises may underestimate the liability for

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such promises. The Board's preliminary view is that the option to receive the higher of a defined benefit or contribution-based promise should be separately recognised and measured at fair value assuming the terms of the benefit promise do not change.

Next steps

IN10 The Board will review the responses to this paper, and modify or confirm its preliminary views. The Board will then develop an exposure draft of amendments to IAS 19 for public comment.

IN11 In doing so, the Board will pay particular attention to the need for users of financial statements to receive relevant and reliable information for assessing the amount, timing and uncertainty of an entity's future cash flows. It will also keep in mind the potential costs to entities of providing this information.

IN12 The constitution of the IASC Foundation requires the Board to consider holding public hearings to discuss proposed standards and to consider undertaking field tests (both in developed countries and in emerging markets) to ensure that its proposed standards are practical and workable. When the Board reviews the responses to this paper, it will decide whether a public hearing would provide input beyond that provided by the comment letters and its Employee Benefits Working Group. The Board does not plan to conduct field tests during the period for comment on this paper. The Board will consider whether field tests would be appropriate later in the project.

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Summary of preliminary views

PV1 The Board's preliminary views are summarised below.

Deferred recognition of changes in defined benefit promises (Chapter 2)

PV2 Entities should recognise all changes in the value of plan assets and in the post-employment benefit obligation in the financial statements in the period in which they occur.

PV3 Entities should not divide the return on assets into an expected return and an actuarial gain or loss.

PV4 Entities should recognise unvested past service cost in the period of a plan amendment.

Presentation approaches for defined benefit promises (Chapter 3)

PV5 The Board does not express a preliminary view on the presentation of the components of post-employment benefit cost in comprehensive income. Instead, the Board outlines three approaches to presentation that illustrate ways in which information about post-employment benefit costs could be presented. The approaches are:

Approach 1: An entity presents all changes in the defined benefit obligation and in the value of plan assets in profit or loss in the period in which they occur.

Approach 2: An entity presents the costs of service in profit or loss. Entities present all other costs in other comprehensive income.

Approach 3: An entity presents remeasurements that arise from changes in financial assumptions in other comprehensive income. Remeasurements arising from changes in financial assumptions are prompted by changes in the discount rate and in the value of plan assets. An entity presents changes in the amount of post-employment benefit cost other than those arising from changes in financial assumptions (eg the costs of service, interest cost and interest income) in profit or loss.

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Definitions (Chapter 5)

PV6 The definitions of post-employment benefits and defined benefit plans in IAS 19 should be revised as follows (new text is underlined and deleted text is struck through):

> *Post-employment benefit*~~*s*~~ <u>*promises*</u> **are** <u>**formal or informal arrangements under which an entity is obliged to provide**</u> **employee benefits (other than termination benefits)** ~~**which are**~~ **payable after the completion of employment.**
>
> <u>**A**</u> ~~*D*~~<u>*d*</u>*efined benefit* <u>*promise*</u> <u>**is a**</u> ~~*plans*~~ ~~**are**~~ **post-employment benefit** <u>**promise that is not a contribution-based promise**</u> ~~**plans other than defined contribution plans**~~**.**

PV7 A definition of contribution-based promises should be introduced as follows:

> **A** ***contribution-based promise*** **is a post-employment benefit promise in which, during the accumulation phase, the benefit can be expressed as:**
>
> **(a) the accumulation of actual or notional contributions that, for any reporting period, would be known at the end of that period, except for the effect of any vesting or demographic risk; and**
>
> **(b) any promised return on the actual or notional contributions is linked to the return from an asset, group of assets or an index. A contribution-based promise need not include a promised return.**

PV8 The definitions of 'post-employment benefit plans' and 'defined contribution plans' in IAS 19 should be deleted.

Recognition issues related to contribution-based promises (Chapter 6)

PV9 An entity should recognise both vested and unvested contribution-based promises as a liability.

PV10 An entity should allocate the benefits earned under a contribution-based promise to periods of service in accordance with the benefit formula.

PV11 There should be no requirement to recognise an additional amount determined by the benefit that an employer would have to pay when an employee leaves employment immediately after the reporting date.

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Measurement of contribution-based promises (Chapter 7)

PV12 An entity should measure its liability for a contribution-based promise at fair value assuming the terms of the benefit promise do not change.

Measurement of promises after the accumulation phase (Chapter 8)

PV13 An entity should measure the liability for benefits in the payment and deferment phases in the same way as it measures them in the accumulation phase.

Disaggregation, presentation and disclosure of contribution-based promises (Chapter 9)

PV14 An entity should disaggregate changes in the value of the liability for a contribution-based promise into a service cost and other value changes.

PV15 An entity should present in profit or loss all changes in the value of the liability for a contribution-based promise and all changes in the fair value of any plan assets.

Benefit promises with a 'higher of' option (Chapter 10)

PV16 When a post-employment benefit promise is the higher of a defined benefit promise and a contribution-based promise, an entity should recognise and account for the 'host' defined benefit promise in the same way as a defined benefit promise. The entity should recognise separately the 'higher of' option.

PV17 An entity should measure the 'higher of' option that is recognised separately from a host defined benefit promise at fair value assuming the terms of the benefit promise do not change.

PV18 An entity should disaggregate changes in the liability for a 'higher of' option that is recognised separately from a host defined benefit promise into a service cost and other changes in value, with both components recognised in profit or loss.

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Invitation to comment

ITC1 The Board invites comments on all matters in this paper, particularly on the questions set out below. Comments are most helpful if they:

- comment on the questions as stated.
- indicate the specific paragraph or paragraphs to which the comments relate.
- contain a clear rationale.
- describe any alternatives the Board should consider.

ITC2 Respondents need not comment on all of the questions. The Board is not seeking comment on any additional issues at this time.

ITC3 The Board will consider all comments received in writing by **26 September 2008**.

Scope of the project

ITC4 The project targets specific issues. Chapter 1 describes how the scope of the project was determined and notes further issues that might be considered in a more comprehensive review. The European Financial Reporting Advisory Group has recently published a discussion paper *The Financial Reporting of Pensions*[*] that considers some of these further issues.

> **Question 1**
>
> Given the objective of the IASB project to address specific issues in a limited time frame, are there additional issues which you think should be addressed by the Board as part of this project? If so, why do you regard these issues as a matter of priority?

[*] When releasing a document for public consultation, the IASB's policy is to alert readers to alternative proposals. The IASB has not discussed these alternative proposals and thus reference does not signal the IASB's endorsement. Rather, the reference is meant to facilitate consideration of the alternatives by interested parties.

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Recognition and presentation of defined benefit promises

ITC5 Chapter 2 describes the Board's deliberations on the recognition of defined benefit promises. The Board's preliminary views are summarised in paragraphs PV2–PV4.

Question 2

Are there factors that the Board has not considered in arriving at its preliminary views? If so, what are those factors? Do those factors provide sufficient reason for the Board to reconsider its preliminary views? If so, why?

ITC6 Chapter 3 sets out alternative approaches for the presentation of components of the defined benefit cost and analyses the relative merits of each approach. These approaches are summarised in paragraph PV5.

Question 3

(a) Which approach to the presentation of changes in defined benefit costs provides the most useful information to users of financial statements? Why?

(b) In assessing the usefulness of information to users, what importance do you attach to each of the following factors, and why:

  (i) presentation of some components of defined benefit cost in other comprehensive income; and

  (ii) disaggregation of information about fair value?

(c) What would be the difficulties in applying each of the presentation approaches?

Question 4

(a) How could the Board improve the approaches discussed in this paper to provide more useful information to users of financial statements?

(b) Please explain any alternative approach to presentation that provides more useful information to users of financial statements. In what way does your approach provide more useful information to users of financial statements?

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Definition of contribution-based promises

ITC7 This discussion paper introduces a new category of post-employment benefit promises—'contribution-based' promises (Chapter 5). The Board's preliminary view is that contribution-based promises should be accounted for as described in Chapters 6–9.

ITC8 The Board's intention in defining contribution-based promises is to capture those promises for which the measurement requirements of IAS 19 are difficult to apply. However, in trying to find an appropriate and conceptual way to distinguish these promises, the Board has included in the scope of the project some promises for which the measurement requirements of IAS 19 are not particularly difficult to apply. In particular, the scope includes promises in which the benefit includes a fixed return on contributions.

Question 5

Do you agree that the Board has identified the appropriate promises to be addressed in the scope of this project? If not, which promises should be included or excluded from the scope of the project, and why?

Question 6

Would many promises be reclassified from defined benefit to contribution-based under the Board's proposals? What are the practical difficulties, if any, facing entities affected by these proposals?

ITC9 Contribution-based promises, as defined in this paper, include promises that IAS 19 classifies as defined contribution plans. The Board does not intend this proposal to lead to significant changes in the accounting for most promises that meet the definition of defined contribution plans in IAS 19.

Question 7

Do the proposals achieve that goal? If not, why not?

Recognition issues related to contribution-based promises

ITC10 Chapter 6 discusses recognition issues related to contribution-based promises. The Board's preliminary views are summarised in paragraphs PV9–PV11.

Question 8

Do you have any comments on those preliminary views? If so, what are they?

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Measurement of contribution-based promises

ITC11 Chapter 7 describes the Board's deliberations on the measurement of contribution-based promises. The Board's preliminary view is that entities should measure the liability for a contribution-based promise at fair value assuming the terms of the benefit promise do not change. The Board reasons that fair value assuming the terms of the benefit promise do not change meets the measurement objectives described in this paper, ie it is based on:

(a) explicit, unbiased, market-consistent, probability-weighted and current estimates of the cash flows;

(b) current market discount rates that adjust the estimated future cash flows for the time value of money; and

(c) the effect of risk, other than the risk that the terms of the benefit change.

Question 9

(a) Are there alternative measurement approaches that better meet the measurement objectives described in this paper? Please describe the approaches and explain how they better meet the measurement objectives.

(b) To what extent should the effect of risk be included as a component of the measurement approach at this stage of the Board's post-employment benefit promises project? How should this be done?

ITC12 The definitions of contribution-based and defined benefit promises rely on the nature of the benefit promise during the accumulation phase. The Board's preliminary view is that the liability for benefits in the payment and deferment phases should be measured in the same way as they are in the accumulation phase, even though this could result in the same liability being measured in different ways depending on the way it was accumulated. The Board's reasons are set out in Chapter 8.

Question 10

(a) Do you agree that the liability for benefits in the payout and deferment phases should be measured in the same way as they are in the accumulation phase? If not, why?

(b) What are the practical difficulties, if any, of measuring the liability for a contribution-based promise during the payout phase at fair value assuming the terms of the benefit promise do not change?

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Disaggregation, presentation and disclosure of contribution-based promises

ITC13 The Board's preliminary view is that an entity should disaggregate changes in the value of the liability for a contribution-based promise into only a service cost and other value changes. The Board thinks that further disaggregation of changes in the fair value of the liability for a contribution-based promise would be difficult to achieve in an objective way.

ITC14 The Board's preliminary view is that all changes in the value of the liability for a contribution-based promise and all changes in any plan assets should be presented in profit or loss.

Question 11

(a) What level of disaggregation of information about changes in the liability for contribution-based promises is useful to users of financial statements? Why?

(b) Do you agree that it is difficult to disaggregate changes in the contribution-based promise liability into components similar to those required for defined benefit promises? If not, why not?

Question 12

Should changes in the liability for contribution-based promises:

(a) be presented in profit or loss, along with all changes in the value of any plan assets; or

(b) mirror the presentation of changes in the liability for defined benefit promises (see Chapter 3)?

Why?

Benefit promises with a 'higher of' option

ITC15 The Board's preliminary views on benefit promises in which the benefit is the higher of a defined benefit promise and a contribution-based promise are summarised in paragraphs PV16–PV18.

Question 13

(a) What are the practical difficulties, if any, in identifying and measuring the 'higher of' option that an entity recognises separately from a host defined benefit promise?

(b) Do you have any other comments on the proposals for benefit promises with a 'higher of' option? If so, what are they?

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Other matters

ITC16 The Board intends to review the disclosures required about post-employment benefit promises in a later stage of this project. As part of that review, the Board intends to consider best practice disclosures in various jurisdictions. For example, explicit requirements to disclose information about the mortality rates used to measure post-employment benefit liabilities could be introduced to allow users to understand the inherent uncertainties affecting the measurement of those liabilities.

Question 14

What disclosures should the Board consider as part of that review?

Question 15

Do you have any other comments on this paper? If so, what are they?

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Chapter 1 Introduction

Reasons for this project

1.1 This discussion paper is the first step in a project by the International Accounting Standards Board on accounting for post-employment benefit promises. Accounting for such benefits is an important financial reporting issue. There is widespread concern about the adequacy of the accounting for such benefits. For instance, the deferred recognition model could result in an asset being recognised when a plan is in deficit or a liability when a plan is in surplus. Also, some take the view that the measurement required by IAS 19 does not give a faithful representation of the liability for a benefit promise in some circumstances.

1.2 Anecdotal evidence and academic research suggest that, although users of financial statements agree that post-employment benefit promises pose a significant risk, many of them do not understand the information that entities provide about post-employment benefit promises. Both users and preparers of financial statements have criticised the existing accounting requirements for failing to provide high quality, transparent information about post-employment benefit promises.

1.3 The Board has been urged to review the accounting for post-employment benefit promises. In the Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2003 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers, the staff of the US Securities and Exchange Commission recommended that the IASB and the US Financial Accounting Standards Board (FASB) should jointly address defined benefit pension plan accounting. Similarly, in comment letters responding to the IASB's previous projects to improve IAS 19 *Employee Benefits*, many respondents stated that a comprehensive review of the accounting for post-employment benefit promises is necessary to improve the quality and transparency of financial statements. Accordingly, in July 2006 the Board added to its agenda a project on the accounting for post-employment benefit promises. The need for such a project has been further supported by the European Financial Reporting Advisory Group, which in January 2008 published a discussion paper *The Financial Reporting of Pensions*, the objective of which is to take a fresh look at—and stimulate discussion on—the principles that might be reflected in future accounting standards on pension benefits that are related to employment.

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Process

Scope of the project

1.4 A comprehensive project to address all areas of post-employment benefit accounting could take many years to complete. The Board recognises that there is a short-term need to provide users of financial statements with better information about post-employment benefit promises. Accordingly, the Board decided to undertake a project of targeted improvements to IAS 19.

1.5 In this project, the Board aims to deliver improvements that address major flaws in the recognition and measurement of the entity's liability for post-employment benefit promises. This can be achieved on a timely basis only by limiting the scope of the project. Although a scope limitation requires some compromises, the Board thinks that the potential improvements set out in this paper are worthwhile.

1.6 In determining the scope of the project, the Board used the following criteria:

(a) the issue causes current problems for preparers in applying IAS 19.

(b) there are alternative solutions to the problem that do not fundamentally change the techniques currently used to measure post-employment benefit obligations for typical defined contribution and typical final salary plans.

(c) the change would improve the decision-usefulness of financial reporting and make the amounts reported in the financial statements more understandable.

1.7 As a result, the Board decided to include the following items in the scope:

- the deferred recognition of some gains and losses arising from defined benefit plans
- presentation of defined benefit liabilities, including the presentation of settlement and curtailment expenses
- accounting for benefits that are based on contributions and a promised return, including the clarification of definitions
- accounting for benefit promises with a 'higher of' option.

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Employee Benefits Working Group

1.8 The Board established an Employee Benefits Working Group to help in this project by providing a variety of expert perspectives, including those of actuaries, auditors, preparers and users of financial statements, and regulators. The group consists of senior professionals with extensive practical experience in the operation, management, valuation, financial reporting, auditing or regulation of a variety of post-employment benefit arrangements.

1.9 The group met in June 2007. Members of the group also assisted the Board in reviewing an early draft of this paper. The Board greatly appreciates the time and energy that group members have devoted to this process and the quality of their contributions. Their comments and insights on the proposals in the paper have been very helpful. The Board looks forward to continued input from the group as it develops the proposals in this paper into an exposure draft.

Other issues

1.10 The Board acknowledges that this project does not encompass a comprehensive review of post-employment benefit accounting. Although the Board recognises the disadvantages of successive changes to accounting for post-employment benefit promises, it concluded that the proposals in this paper have the potential to improve the accounting for post-employment benefit promises significantly in the short term. Also, the Board expects that any requirements that result from this project will be in place for some time.

1.11 Other issues that could be considered include:

- **Recognition of the obligation based on the benefit formula.** IAS 19 relies on the benefit formula to determine the obligation that an entity recognises for post-employment benefit promises. This means that the entity recognises unvested benefits as a liability. This is inconsistent with the recognition of liabilities in other International Financial Reporting Standards (IFRSs). A review of this topic would include consideration of recognising unvested benefits as a liability and how to recognise the liability when the benefit formula attributes benefits unevenly over the service life of the employee.
- **Measurement of the obligation.** The measurement model in IAS 19 is fundamentally different from the measurement models in other IFRSs. Some contend that IAS 19's requirement to measure the post-employment benefit obligation on the basis of the projected

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benefit (including salary increases) is fundamentally flawed. This was a common complaint in the comment letters the FASB received related to SFAS 158 *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*. A comprehensive review of measurement would include:

(i) the use of the projected unit credit (PUC) method to compute the present value of the future benefits, and consideration of alternative measurement methods for all types of benefit arrangements. These measurement methods include accumulated benefit, projected benefit, fair value and settlement value.

(ii) the criteria for selecting input assumptions, including the discount rate.

- **Presentation of a net obligation, rather than consolidation of gross pension assets and gross liabilities in the sponsor's financial statements.** IAS 19 assumes that the sponsoring entity does not control the fund and requires entities to recognise the net pension deficit or surplus. If the sponsoring entity did control a fund, the sponsoring entity would consolidate the fund in its financial statements. A review of this topic would consider the application of the Board's project on consolidations to post-employment benefit arrangements.
- **Multi-employer plans.** For a multi-employer defined benefit plan, IAS 19 requires an entity to account for its proportionate share of the defined benefit obligation, plan assets, and costs associated with the plan in the same way as for a single-employer defined benefit plan. However, IAS 19 provides an exemption from defined benefit accounting when sufficient information is not available. In that case, the entity applies defined contribution accounting and discloses that fact. This means that the entity may not recognise its share of some plan liabilities in its financial statements.

1.12 The Board intends to work with the FASB in the future to address these other issues and work towards a common standard on post-employment benefit promises. Paragraphs 1.14–1.16 place this project in the context of the FASB's project on post-retirement benefits.

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The context of this project

1.13 This section places this project in the context of other standard-setting projects, in particular the FASB's project on post-retirement benefits, the Board's financial statement presentation project and other IASB projects.

The FASB's project on post-retirement benefits

1.14 The FASB issued SFAS 158 in September 2006. It was the result of the first phase of the FASB's project on post-retirement benefits, and requires entities to recognise:

(a) the full post-retirement benefit obligation in the statement of financial position;

(b) the existing post-retirement benefit cost in the income statement in accordance with existing SFAS 87 *Employers' Accounting for Pensions*, SFAS 88 *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and Termination Benefits* and SFAS 106 *Employers' Accounting for Postretirement Benefits Other Than Pensions* with the deferred recognition features in place; and

(c) amounts that arise during the period but are not recognised as components of net periodic benefit cost through other comprehensive income. These amounts are recycled in accordance with the deferred recognition features of SFAS 87, SFAS 88 or SFAS 106.

1.15 The IASB's project has aims different from those of the FASB's first phase. However, both boards regard a common standard on post-employment benefit promises as the ultimate goal. The boards share the same problem: a need for short-term improvements in, and a comprehensive reconsideration of, post-employment benefit accounting. However, they favoured different approaches to short-term improvements. In particular, the IASB:

- is reluctant to introduce recycling into a standard that currently does not require it, pending its work in the financial statement presentation project.
- has been urged in previous consultations to address sooner rather than later issues relating to recognition and presentation.
- has been urged in previous consultations to address the measurement of benefits based on contributions and asset-based returns.

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1.16 Consequently, the FASB and IASB projects should be viewed as parallel projects. Each board monitors the other's work and learns from the other's experience. In particular, both boards will benefit from comment letters received on the other's consultation documents. The IASB and FASB will review how to achieve a common standard after the IASB completes this project. Until then, the FASB intends to continue work on aspects of its second phase that will provide an opportunity for the boards to begin working together.

Financial statement presentation

1.17 In April 2004 the IASB and FASB started a joint project on financial statement presentation that combined their projects on performance reporting. The objective of that project is to establish a common standard on how to present financial statements.

1.18 The IASB published the output of its first phase of the financial statement presentation project as a revised version of IAS 1 *Presentation of Financial Statements* in September 2007. The revised IAS 1 requires entities to present a statement or statements of comprehensive income that include all non-owner changes in equity.

1.19 The second phase of that project addresses fundamental issues of presentation, including:

- developing principles for aggregating and disaggregating information in each financial statement.
- defining the totals and subtotals that entities should present in each financial statement (which might include categories such as business and financing).
- deciding whether entities should recycle components of other comprehensive income/other recognised income and expense to profit or loss and, if so, the characteristics of the transactions and other events and circumstances whose amounts should be recycled and when recycling should occur.
- reviewing the requirements for statements of cash flows, including whether to require the use of the direct or indirect method of computing cash flow from operations.

1.20 A discussion paper for that second phase is expected to be published in the second quarter of 2008. Accordingly, discussion documents on both the financial statement presentation project and this project will be open for comment at the same time.

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1.21 The Board noted concerns that this paper would present proposals that rely on IAS 1 when IAS 1 is subject to further amendment by the financial statement presentation project. However, the Board did not want to risk delays to one project causing delays to another. When each project is conducted independently, completion of one project does not rely on completion of the other. In particular, the Board did not want to imply that its proposals in this project would be finalised only if its proposals in the financial statement presentation project were finalised. If the financial statement presentation project were delayed, this project would be completed in the context of IAS 1 (as revised in 2007).

1.22 Accordingly, the proposals in Chapters 3 and 9 assume that the entity applies IAS 1 (as revised in 2007). However, the Board expects that the comments received on this paper will be relevant in considering the presentation of post-employment benefit costs in the financial statement presentation project.

Other projects

1.23 The Board's conclusions in other projects, including fair value measurement, financial instruments, revisions to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, and aspects of the conceptual framework project, will be important to any discussion on the accounting for post-employment benefit promises. The Board intends its work on its post-employment benefit promises project to proceed in parallel with these other projects and it does not propose to wait for their outcome. This paper may generate useful inputs for those other projects and conclusions reached in other projects may inform the Board's work on accounting for post-employment benefit promises.

Next steps

1.24 Before beginning work on an exposure draft, the Board will review the responses to this paper and decide whether to modify or confirm its preliminary views. The exposure draft will set out the Board's views as a result of that review. In doing so, the Board will pay particular attention to the need for users of financial statements to receive relevant and reliable information for assessing the amount, timing and uncertainty of an entity's future cash flows. The Board will also keep in mind the potential costs to entities of providing this information.

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Chapter 2 Deferred recognition of changes in the liability for defined benefit promises

2.1 This chapter considers the requirements and options in IAS 19 for the deferred recognition of some gains and losses relating to defined benefit promises.

2.2 The Board's preliminary views are:

- Entities should recognise all changes in the value of plan assets and in the defined benefit obligation in the financial statements in the period in which they occur (paragraphs 2.3–2.12).
- Entities should not divide the return on assets into an expected return and an actuarial gain or loss (paragraphs 2.13–2.15).
- Entities should recognise unvested past service cost in the period of a plan amendment (paragraphs 2.16–2.21).

Changes in plan assets and the defined benefit obligation

2.3 IAS 19 permits entities to recognise some changes in the value of plan assets and in the defined benefit obligation in periods after the period in which they occur. Specifically, it permits entities:

- to leave unrecognised actuarial gains and losses within a 'corridor' (the greater of 10 per cent of plan assets and 10 per cent of plan liabilities).
- to defer recognition of actuarial gains and losses that exceed the corridor. Entities can recognise the gains and losses that exceed the corridor over the service lives of the employees.

2.4 IAS 19 permits entities to adopt any systematic method that results in recognition of actuarial gains and losses faster than the minimum requirements it specifies. In addition, it permits immediate recognition of all gains and losses, either in profit or loss or in other comprehensive income.

2.5 The deferred recognition model in IAS 19 treats the recognition of changes in defined benefit obligations and in plan assets differently from changes in other assets and liabilities. These requirements were developed to accommodate the following views:

- Some expressed the view that entities cannot measure post-employment benefit obligations as reliably as other items

recognised in financial statements because it is impossible to predict accurately for a period (or over several periods) salary levels, length of employee service, mortality, retirement ages and other pertinent events. Thus, a revision in the estimate of the obligation in one period need not result from the events of that period. It may also arise from changes to assumptions made during the period. As a result, those holding this view think that the volatility in profit or loss that could result from reporting period-to-period revisions of estimates does not give a faithful representation of changes in the amount of the post-employment benefit obligation in each period because much of that volatility represents the effect of change in assumptions.

- Some expressed the view that period-to-period changes in the value of plan assets and the defined benefit obligation are not relevant to users of financial statements. They contend that the long periods for which plan assets are held gives the opportunity for some gains or losses on plan assets to reverse or offset each other. Similarly, the long periods before settlement of defined benefit obligations could give changes in estimate that arise in any period an opportunity to reverse. Thus, reporting changes in the fair value of plan assets or the defined benefit obligation each period results in volatility in profit or loss that is not relevant to decisions based on the longer-term prospects of the entity.
- Some expressed the view that, regardless of whether the volatility resulting from immediate recognition of changes in the fair value of plan assets or the defined benefit obligation is a faithful representation of economic events, it is too great to be acceptable in financial statements. The effect of such an accounting methodology would not be useful to users because the volatility associated with the changes in post-employment benefit obligation or plan assets would overwhelm the results and financial position of the business operations.
- Some think that the effects outlined above may cause entities to close their defined benefit plans.

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2.6 When IASC issued IAS 19, it recognised that the immediate recognition approach was consistent within the *Framework*, but concluded that it was not feasible at that time. In particular, IASC stated that immediate recognition could be achieved only when fundamental issues relating to the presentation of financial statements were resolved.* However, the Board has reviewed criticisms of IAS 19 and decided that the benefits of immediate recognition are such that the issue should be readdressed without waiting for the outcome of the project on financial statement presentation.

2.7 The main criticisms of the deferred recognition model are long-standing. In summary:

- An employer with a defined benefit plan is not required to recognise economic changes in the cost of providing post-employment benefit promises—the changes in plan assets and benefit obligations—as those changes take place.
- An entity may recognise an asset when a plan is in deficit or a liability may be recognised when a plan is in surplus.
- It relegates important information about post-retirement plans to the notes to the financial statements.
- The resulting accounting has a level of complexity that makes it difficult for many users of financial statements to understand and adds to the cost of applying IAS 19 by requiring entities to keep complex records.

2.8 The Board regards these criticisms as cause for concern. The Board noted the views in paragraph 2.5 in favour of deferred recognition, but came to the following conclusions.

- The Board rejected views that post-employment benefit obligations are more difficult to measure reliably than other obligations. Those views are based on the observation that most entities do not ordinarily assume obligations of comparable significance that depend on unknown and uncontrollable future events to define the amount required to settle the obligation. The Board noted that the settlement amount of derivative financial instruments, asset retirement obligations and insurance liabilities similarly depend on unknown and uncontrollable future events, such as market forces. The *Framework* acknowledges that entities may suffer 'inherent difficulties either in identifying the transactions and

* Paragraph BC41 of the Basis for Conclusions on IAS 19

other events to be measured, or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events'. However, it notes that 'it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement'. Accordingly, the Board concluded that difficulty in measuring the liability or potential imprecision does not provide sufficient reason not to measure it.

- The Board noted views that possible future offset makes recognising actuarial gains and losses that arise from period to period inappropriate. However, the Board concluded that offset was not inevitable. If the original actuarial assumptions are valid, future fluctuations may offset each other and not offset past fluctuations. The Board concluded that the possibility of future offset does not justify non-recognition of actuarial gains or losses.
- The Board rejected views that volatility resulting from changes in plan assets and post-employment benefit obligations is too great to be acceptable in the financial statements. A measure should be volatile if it represents faithfully transactions and other events that are themselves volatile. Similarly, if post-employment promises and the gains and losses arising from them are, in reality, large compared with those of business operations, the financial statements should reflect that fact.
- In the Board's view, inappropriate accounting should not be continued to disguise the true state of defined benefit plans. The role of accounting is to report transactions and events in a neutral manner, not to give favourable or unfavourable treatment to particular transactions to encourage entities to engage in those transactions or discourage them from doing so. To do so would impair the quality of financial reporting.

2.9 Deferred recognition is not a necessary component of the basic measurement model for defined benefit plans in IAS 19. Thus, the Board concluded that it could address deferred recognition without reconsidering the measurement model generally.

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2.10 Immediate recognition would be consistent with the *Framework* and other IFRSs. For example:

- The *Framework* requires that 'the effects of transactions and other events are recognised when they occur ... and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.'
- Immediate recognition of actuarial gains and losses is consistent with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. IAS 8 requires the effect of changes in accounting estimates to be included in the period of the change to the extent that the change gives rise to changes in assets and liabilities.
- IAS 37 requires changes in liabilities, including changes in long-term liabilities (such as asset retirement obligations), to be recognised in the period they occur.

2.11 Immediate recognition also has the following advantages:

- It represents faithfully the entity's financial position. An entity will recognise an asset only when a plan is in surplus and a liability only when a plan has a deficit.
- It results in amounts in the statements of financial position and comprehensive income that are transparent and easy to understand. The approach generates income and expense items that provide information about changes in the post-employment benefit obligation and plan assets in that period.
- It improves comparability across entities by eliminating the options currently allowed by IAS 19.

2.12 Accordingly, the Board's preliminary view is that entities should recognise all changes in the value of plan assets and in the post-employment benefit obligation in the financial statements in the period in which they occur.

Expected return on assets

2.13 IAS 19 permits entities to recognise in profit or loss an expected return on assets. The difference between the actual and expected return on assets forms part of the actuarial gains and losses that an entity treats as described in paragraphs 2.3 and 2.4.

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2.14 Some users of financial statements hold the view that dividing the actual return on plan assets into an expected return and an actuarial gain or loss provides information that is more relevant than a single item representing the actual return. Those users think that an expected return provides the most relevant information for forecasting future investment returns and hence potential cash contributions to the pension fund. Those users also assert that the expected return provides a benchmark against which to measure the entity's investment performance.

2.15 However, the Board is concerned that the subjectivity inherent in determining the expected rate of return provides entities with an opportunity to choose a rate with a view to manipulating profit or loss. Accordingly, the Board's preliminary view is that entities should not divide the return on assets into an expected return and an actuarial gain or loss.

Plan amendments

2.16 Past service costs arise when an entity introduces a defined benefit plan that attributes benefits to past service or changes benefits attributed to past service under an existing defined benefit plan. IAS 19 requires entities to recognise past service costs from vested benefits immediately, and recognise past service costs from unvested benefits on a straight-line basis over the average period until the benefits vest.

2.17 Because IAS 19 characterises past service cost as increasing the present obligation that arises from employees' past service, the Board's preliminary view is that entities should recognise unvested past service cost in the period of the plan amendment. This approach is also consistent with the approach in SFAS 158, which requires entities to recognise in other comprehensive income unvested prior service cost in the period of the plan amendment.

2.18 The Board noted that some contend that entities amend or introduce plans to remunerate employees for future services, not for service already delivered, even if the terms of those plan amendments attribute benefits to past service periods. For example, the attribution of benefits to past service may be a means of assigning a fixed amount of increased remuneration among existing employees. Those holding this view assert that immediate recognition could misstate employee remuneration because entities would report a higher expense in the year of the plan amendment than in the following years when, in fact, remuneration is stable.

2.19 The Board acknowledged that attributing changes in unvested benefits arising from plan amendments to future service from employees would be consistent with other IFRSs. For example, IFRS 2 *Share-based Payment*

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and the proposed treatment of unvested termination benefits in the exposure draft of amendments to IAS 19 (published in June 2005) regard increases in benefits with a vesting period as attributable to employees' future services until vesting date.*

2.20 This project does not include re-examining the accounting for defined benefit plans based on a benefit formula. If the Board retains the attribution of benefit in accordance with a benefit formula, then unvested past service cost is a liability in accordance with IAS 19. The alternative view, that unvested past service cost should be recognised over the vesting period, would be consistent with what the Board thought were the best conceptual answers in IFRS 2 and the proposed amendments to IAS 19. However that approach would result in deferred recognition of an amount that is regarded as a liability in IAS 19. In other words, immediate recognition of unvested past service cost based on the benefit formula would allow both:

(a) a retention of the general requirement in the existing IAS 19 to attribute benefits to periods of service using the benefit formula, and

(b) consistency with immediate recognition of all gains and losses arising from defined benefit plans

but it would result in an approach that is not consistent with what the Board thinks is the best conceptual answer.

2.21 The Board noted that the accounting for defined benefit liabilities in IAS 19 is different from the accounting for liabilities in other IFRSs. However, the Board recognised that the inconsistency between the accounting model in IAS 19 and IFRS 2 is not an issue to be addressed in this project. The Board's preliminary view is that it should retain the general requirement to attribute benefits to periods of service using the benefit formula and therefore that entities should recognise all effects of changes arising from plan amendments in the period in which the plan amendment took effect.

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* Paragraph BC12 of that exposure draft noted that 'in some cases, termination benefits that are payable in exchange for future service would be calculated using a benefit formula that determines some (or all) of the termination benefits with reference to past service. However, the Board agreed with the FASB that the benefit formula "in and of itself, does not render one-time termination benefits a 'reward' for past service. The [FASB] observed that an objective of providing a 'reward' for past service could be accomplished by granting immediately vested benefits." Accordingly, the Board concluded that such benefits should be recognised over the future service period, even though they are calculated by reference to past service.'

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Chapter 3 Presentation approaches for defined benefit promises

3.1 This chapter considers how entities should present the components of defined benefit costs if the proposals in Chapter 2 to eliminate deferred recognition are implemented.

3.2 Requiring immediate recognition of changes in post-employment defined benefit obligations and plan assets would make it necessary to specify how to present the components of the change. The Board considered views that it should not eliminate deferred recognition of post-employment benefit gains and losses until it has considered issues yet to be addressed in the financial statement presentation project. Chapter 2 discusses the reasons why the Board decided to address deferred *recognition* of gains or losses at this time.

3.3 The presentation of components of post-employment benefit cost has not been considered explicitly by the Board in the statement of comprehensive income introduced by the revised version of IAS 1. Furthermore, the project on financial statement presentation may not specifically address the presentation and display of components of post-employment benefit cost. Therefore, the Board decided that it would take the opportunity in this project to obtain views on the appropriate presentation of components of post-employment benefit costs. The Board concluded that it would be premature to express in this paper a preliminary view on the presentation of the components of defined benefit cost at this stage in its project. Therefore, the Board decided to illustrate three approaches to the presentation of information about defined benefit costs. When developing an exposure draft the Board will decide on proposals for presentation in the light of progress in the project on financial statement presentation and comments received on this paper.

Alternative approaches

3.4 The approaches described below provide different ways to present information about the components of post-employment benefit cost. Those ways could enhance the usefulness of the information provided. The Board assesses usefulness with reference to the qualitative characteristics of financial statements, in particular, relevance.

3.5 The Board noted various views that constituents have expressed about the components of post-employment benefit cost:

- Some users regard post-employment benefit obligations as financing. This is because entities can determine the size of their

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post-employment benefit obligations through decisions about how to finance those obligations. Paragraph 16 of the *Framework* states that 'information about financial structure is useful in predicting future borrowing needs and how future profit and cash flows will be distributed among those with an interest in the entity; it is also useful in predicting how successful the entity is likely to be in raising further finance.'

- Some constituents take the view that some components of changes in post-employment benefit obligations are unusual, abnormal or infrequent, for example those changes that arise from events outside management control. Paragraph 28 of the *Framework* notes that the ability to make predictions from financial statements 'is enhanced … by the manner in which information on past transactions and events is displayed.' Specifically, 'the predictive value of the income statement is enhanced if unusual, abnormal and infrequent items of income or expense are separately disclosed.'
- Separate identification of some components of post-employment benefit cost would provide information about how the employer's performance might vary from period to period. The *Framework* states that this is important in assessing potential changes in the economic resources that the entity is likely to control in the future.

3.6 The Board noted that paragraph 28 of the *Framework* does not provide a sufficient basis for excluding an item from the profit or loss statement simply because it is unusual, abnormal or infrequent. Nevertheless, the Board acknowledged that many constituents are concerned that presenting all components of post-employment benefit cost in profit or loss would inappropriately combine information with different predictive values.

3.7 Furthermore, the Board also noted that revised IAS 1 requires all items of income and expense to be recognised in comprehensive income and none recognised directly in equity.

3.8 The Board was persuaded that it would be a sufficient short-term improvement to require entities to recognise all components of post-employment benefit costs in comprehensive income, compared with the existing non-recognition or deferred recognition of some components. Accordingly, the Board decided not to restrict its thinking to presentation of all components in profit or loss but also to identify approaches for discussion that present some components of post-employment benefit cost in other comprehensive income.

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3.9 The Board acknowledged that an approach that recognises amounts for some components of post-employment benefit cost outside profit or loss would prompt questions about whether any such amounts should be recycled. IAS 19 does not permit inclusion in profit or loss of gains and losses that had been recognised in other comprehensive income in an earlier period. In the Basis for Conclusions on IAS 19, the Board noted 'there is not a consistent policy on recycling in IFRSs'. It also noted that 'The question of recycling ... remains open in IFRSs' and that it 'does not believe that a general decision on the matter should be made in the context of [amendments to IAS 19]. The decision [...] not to recycle actuarial gains and losses is made because of the pragmatic inability to identify a suitable basis'. The Board remains convinced by this logic for this project.

The approaches

3.10 The three approaches set out below present information about post-employment benefit cost in different ways. Each approach seeks to present information that is useful, drawing on constituents' expressed options and views, and discussion from the Board's other projects. Paragraphs 3.17–3.32 discuss the advantages and disadvantages of the approaches.

Approach 1

3.11 Entities present all changes in the defined benefit obligation and in the value of plan assets in profit or loss.

Approach 2

3.12 Changes in the defined benefit obligation and the value of plan assets are split into the cost of service and the effect of deferred settlement of that cost. Entities present only the costs of service in profit or loss. Entities present all other costs in other comprehensive income.

3.13 Accordingly entities present:

- service costs (both costs arising during the period and any past service costs) and changes in service costs caused by changes in assumptions other than the discount rate in profit or loss.
- all other costs in other comprehensive income. These include interest cost, the effects of changes in the discount rate, and all changes in the value of plan assets.

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3.14 The Board considered whether approach 2 should present in profit or loss only service cost, and not changes in service costs arising from changes in assumptions other than the discount rate. The Board thinks that the gains or losses associated with service costs are a re-estimate of service costs and should be accounted for in the same way. To do otherwise might encourage misestimation of service costs to achieve an accounting result.

Approach 3

3.15 Entities present remeasurements that arise from changes in financial assumptions in other comprehensive income. Remeasurements relating to financial assumptions are prompted by changes in the discount rate and in the value of plan assets. Entities present changes in the amount of post-employment benefit cost other than those arising from changes in financial assumptions (eg the costs of service, interest cost and interest income) in profit or loss.

3.16 In this approach, interest cost on the defined benefit obligation and interest income on plan assets would be presented in profit or loss. As discussed in paragraph 3.19, many constituents think that interest cost on benefit liabilities should be offset by interest income on plan assets. However, the Board found it difficult to distinguish interest income on plan assets from other changes in the value of plan assets. Paragraph 3.29 discusses ways to estimate interest income on plan assets.

Discussion of the three approaches

Consistency with other IFRSs

3.17 Some think that only approach 1 is consistent with the *Framework* and IAS 1, and that it is the most consistent with other IFRSs. This is because:

- the *Framework* states that items of income and expense are presented in the income statement and IAS 1 provides no principle for recognising items. Items recognised outside profit or loss in other comprehensive income, in specific standards, are ad hoc exceptions. Approach 1 removes from IAS 19 the option to use one of these exceptions and does not require the Board to create further exceptions.
- Approach 1 is consistent with other IFRSs, including:
  - (i) IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, which requires entities to include the effect of changes in accounting estimates to be included in profit or loss for the

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period if the change affects the current period but not future periods; and

(ii) IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, which requires entities to recognise changes in liabilities, including changes in long-term liabilities (such as an asset retirement obligation), in profit or loss in the period they occur.

Approaches 2 and 3, in recognising components in other comprehensive income, are inconsistent with the general approach in some IFRSs. In particular, approach 2, which requires interest cost to be presented in other comprehensive income, would be inconsistent with most other IFRSs, which require interest cost to be recognised in profit or loss.

3.18 However, others think that approaches 2 and 3 would provide more useful information to users of financial statements because they separate gains or losses arising from events that have different predictive implications. The Board noted that many constituents are resistant to recognising all changes in defined benefit obligations and related plan assets in the period in which they occur. Those constituents are concerned that presenting all those changes in profit or loss would inappropriately combine information with different predictive implications. For example, a fall in profit caused by an increase in the cost of raw materials provides information of a different predictive value from an equivalent fall in profit arising from an increase in a pension cost due to market movements in asset prices or interest rate changes. In particular, some think that approach 3 would recognise amounts in other comprehensive income that are similar to revaluation gains and losses that are recognised in other comprehensive income in accordance with IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*. Those holding this view think that approaches 2 and 3 provide decision-useful information that does not combine information with different significance.

Perceived relations between components

3.19 Some think that, if some components of post-employment benefit cost are presented in other comprehensive income, it is important to examine potential relations between components. Those most often suggested are the relations between:

- interest cost on the post-employment benefit obligation and interest income on plan assets. Many regard this relationship as an

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important economic effect of a funded plan. The interest cost that arises from discounting the post-employment benefit obligation represents changes in the amount of the liability because of the passage of time. Thus, some think that entities should offset interest cost on defined benefit obligations by interest income on plan assets that also arises because of the passage of time. All approaches achieve offset between interest cost and interest income by recognising both components either in profit or loss or outside profit or loss.

- the total return on plan assets and the change in the post-employment benefit obligation. Many think that a relation exists between the effects of changes in economic assumptions, particularly interest rates, on plan assets and benefit liabilities. Thus, they think that presentation of changes in plan assets should be consistent with the presentation of changes in the benefit liability. All approaches permit some offset between changes in plan assets and changes in the benefit liability.

Remeasurements

3.20 Preparers regularly maintain that profit should be a reflection of operations, a business model or management control. They often assert that price changes on long-term items are external to operations, the business model or management control. Similarly, some think that revenues and expenses, including post-employment benefit service costs, have a different predictive value from gains or losses that represent changes in the present value of future cash flows arising from changes in market rates and market values.

3.21 Although many price changes are recognised in profit or loss, some observe that the items currently presented in other comprehensive income are price or value changes of a long-term item.

3.22 Approach 1 does not differentiate between remeasurement changes and other costs. Approach 2 would include in other comprehensive income an item that is not a remeasurement change (ie interest cost), and thus is different from the other items currently there. Approach 3 draws on the view that items currently presented in other comprehensive income are price or value changes by presenting changes in price of the obligation and in the fair value of plan assets in other comprehensive income.

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Financing

3.23 Employee benefit plans involve deferred payment of a current benefit. Thus, the components of benefit cost for each period include both the current benefit and the effects of deferring payment of benefits from the current and previous periods. Some users favour separate presentation of financing costs and costs relating to employee service during the period. Although they regard information about financing as useful and relevant to users, they consider financing different from operating and other business activities.

3.24 In contrast, some preparers regard defined benefit cost as a single operating component. They regard post-employment benefit promises as relating to employee service costs. Those preparers do not favour disaggregating the benefit costs into a financing component and an operating component.

3.25 Approach 2 provides a clear distinction between the operating and financing components of post-employment benefit promises by recognising only service costs in profit or loss and recognising financing costs in other comprehensive income. Approaches 1 and 3 do not present the financing component of post-employment benefit promises in a separate component of comprehensive income. However, this information is available in the notes to financial statements and entities could present the financing component separately in profit or loss.

Disaggregation of fair value changes

3.26 Some think that information about disaggregated changes in the fair value of assets is not decision-useful for financial instruments and may not be useful for post-employment liabilities. Others think that information about interest income is useful to users of financial statements. Approaches 1 and 2 do not require disaggregation of changes in the fair value of assets. Approach 3 requires entities to disaggregate interest income on plan assets from other changes in fair value of plan assets.

Practicality

3.27 Approach 1 avoids the need for any arbitrary and potentially complex rules about the allocation of cost to profit or loss and in other comprehensive income. Also, IAS 19 permits approach 1. The Board regards approach 1 as the least complex to implement and understand.

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3.28 Approaches 2 and 3 require entities to divide actuarial gains and losses identified in IAS 19 into those arising from interest rate changes and other changes. Because of relations between those changes, the Board would need to specify how to calculate the amount to ensure consistency.

3.29 Approach 3 requires some method, yet to be determined, of identifying interest income on plan assets. The Board considered three ways to estimate interest income on plan assets:

- using the expected return on plan assets, as currently required by IAS 19.
- using dividends received on equity plan assets and interest earned on debt plan assets (using the current rate market participants would require for equivalent assets).
- using market yields at the reporting date on high quality corporate bonds to input interest income.

3.30 The following observations apply to these approaches:

- In the Board's preliminary view, entities should not divide the return on assets into an expected return and an actuarial gain or loss. This is discussed in Chapter 2.
- Recognising only dividends on equity plan assets would result in entities recognising returns from dividend-paying equity investments separately from returns from non-dividend-paying equity investments. This could create an incentive for some entities to invest in particular plan assets to achieve an accounting result, rather than for economic reasons. This would result in financial statements that are not neutral. The Board also noted that the distinction between dividends and other changes in fair value is not an important economic distinction.
- The objective of imputing interest income using market yields on high quality corporate bonds is to recognise in profit or loss net interest based on the net surplus or deficit arising from the promise. However, the disadvantage is that some may take the view that the imputed interest on plan assets is not economically meaningful information.

3.31 Because information about interest income is not required by IAS 19 at present, the Board regards approach 3 as the most complex approach to implement.

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Conclusions

3.32 The three approaches try to accommodate as many constituent views as possible, while requiring immediate recognition of all gains and losses in comprehensive income. The Board did not include as a possible approach the existing option in IAS 19, which allows all actuarial gains and losses to be recognised in other comprehensive income, because:

(a) it recognises the effect of changes in assumptions on the service cost in other comprehensive income and

(b) it requires the determination of an expected return on plan assets. As discussed in Chapter 2, the Board's preliminary view is that the current presentation option in IAS 19, which allows entities to recognise expected return in the profit or loss, is too subjective.

Presentation of gains or losses on settlements and curtailments

3.33 IAS 19 already requires entities to recognise gains or losses on the curtailment or settlement of a defined benefit plan when the curtailment or settlement occurs. The gains and losses are required to be recognised in profit or loss. The Board's preliminary view is that entities should recognise gains or losses on curtailment or settlement in accordance with each of the three approaches in paragraphs 3.11–3.16.

3.34 A curtailment occurs when an entity takes an action that reduces the benefits of the plan, either by reducing the number of employees covered by the plan, or by amending the terms of the plan so that a material element of future service by current employees qualifies for reduced or no benefits. The Board reasons that the change in the benefit obligation that occurs in a curtailment arises because of a change in the estimated cost of the employee service for which remuneration has been deferred. Accordingly, the gain or loss on a curtailment is a service cost, and should be presented in profit or loss for all three approaches. This is consistent with the existing requirements of IAS 19.

3.35 A settlement occurs when an entity enters into a transaction that eliminates all future legal or constructive obligations for part or all of the benefits provided in a defined benefit plan. The Board reasons that the gain or loss on settlement arises from the entity's decisions about when it settles its obligation for past service. The gains or losses arise because

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the settled price differs from the amount of the obligation determined in accordance with IAS 19. Accordingly, entities would recognise gains or losses on settlement:

- in profit or loss in approach 1.
- in other comprehensive income in approach 2. This is because they do not arise from service costs.
- in other comprehensive income in approach 3. This is because any gains and losses may be regarded as a remeasurement.

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Chapter 4 Introduction to contribution-based promises

4.1 The Board's preliminary views on the accounting for contribution-based promises and promises with a 'higher of' option are set out in the remaining chapters of this paper.

4.2 This chapter describes the background to the Board's decision to address the accounting for these types of post-employment benefit promises, for which the application of IAS 19 has caused particular problems in practice. The promises considered are:

- post-employment benefit promises that promise a specified return on contributions. They include benefits commonly described as cash balance plans. The Board proposes to call these promises 'contribution-based' promises.
- post-employment benefit promises that promise the higher of a defined benefit promise or a contribution-based promise. The Board proposes to call these promises with a 'higher of' option.

4.3 Chapter 5 examines the definition of contribution-based promises and the consequential implications for the definitions in IAS 19.

4.4 Chapter 6 looks at the following issues relating to the recognition of the liability for contribution-based promises:

- unvested contribution-based promises
- allocation of contribution-based promises
- contribution-based promises in which the amounts payable to employees, if they leave service immediately after the reporting date, exceed the amount recognised in the statement of financial position.

4.5 Chapters 7–9 explore the measurement and presentation of the entity's liability for contribution-based promises as follows:

- the characteristics of the appropriate measurement attribute (Chapter 7)
- the measurement of all post-employment benefit promises after the accumulation phase (Chapter 8)
- the presentation of components of contribution-based promises (Chapter 9).

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4.6 Chapter 10 discusses the accounting for benefit promises with a 'higher of' option.

Background

4.7 IAS 19 identifies two categories of post-employment benefit promises: defined benefit and defined contribution. Defined contribution promises are those in which the 'entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.'* Thus, promises are defined contribution only if the employer pays the contributions into a separate fund, from which the employee receives a lump sum benefit at retirement equal to the contributions plus the actual return on plan assets. All other promises are defined benefit promises. A typical example of a defined benefit promise is a final salary plan that promises a benefit equal to 2 per cent of final salary for each year of employee service.

4.8 For some time, typical defined benefit and defined contribution promises were common. However, in some jurisdictions, there has been a shift to promises that combine features of defined benefit and defined contribution promises and provide new features, such as guarantees.

4.9 In 2002 the International Financial Reporting Interpretations Committee (IFRIC) was asked for guidance on how to account for promises with a promised return on contributions or notional contributions. Such promises meet the definition of defined benefit plans in IAS 19. The IFRIC was informed that the following problems arise in applying IAS 19 to those plans:

- **Attribution of benefit to periods of service.** IAS 19 requires entities to allocate benefits to periods of service in accordance with the benefit formula, unless the benefit formula attributes materially higher benefits to later periods of service. In the latter case, IAS 19 requires entities to allocate the benefits on a straight-line basis. Because many plans with a promised return on contributions express the benefit in terms of the employee's current salary, the question arises whether entities should include expected future salary increases in determining whether materially higher benefits are allocated to later periods of service.

* IAS 19, paragraph 7

- **Measurement of any benefit that depends on future returns on assets.** Some take the view that IAS 19 requires entities to measure the obligation for a benefit that depends on future returns on assets by projecting forward the benefit using its best estimate of the rate of return on the specified assets and then discounting that amount using a high quality corporate bond rate. However, this discount rate is not appropriate for benefits that depend on future returns on assets because it does not reflect the risk of those assets. Some think that applying this method to benefits that depend on future returns on assets does not provide useful information. They think it is equivalent to valuing CU100 of equities by projecting CU100 forward at the expected rate of return on equities and discounting that amount to a present value at the rate of return on high quality corporate bonds. That present value will not equal CU100.

- **Measurement of a benefit that includes a comparison of two amounts.** A benefit could be expressed as specified contributions plus the actual return on the assets in which the contributions are invested, with a guarantee that the return will equal or exceed a fixed percentage. IAS 19 requires the defined benefit obligation to be measured using best estimate assumptions at the reporting date. Accordingly, IAS 19 would measure the obligation as the higher of the two alternatives based on those assumptions. It would not attribute any value to the existence of the alternative measure, even though its existence adds value to the benefit.

4.10 In July 2004 the IFRIC published Draft Interpretation D9 *Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions*. In May 2006, however, the Board decided to undertake a project on post-employment benefit promises. In determining the scope of the project, the Board noted that resolution of the issues raised in D9 could require an approach that would not be consistent with IAS 19. The Board also noted that plans with a promised return on contributions or notional contributions were increasingly common. The reasons include:

- They are appropriate for a mobile workforce because the benefits vest evenly over the working life of an employee and changes of employer have less impact on the total benefit received.

- They are better understood and therefore potentially more highly valued by employees.

- They reduce the risks for the employer and, depending on the contributions and rate of return offered, can reduce the costs.

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4.11 Accordingly, the Board decided to include the accounting for these plans in this project. In the light of that decision, the IFRIC suspended its redeliberations on D9.

4.12 Because the Board intends to complete this project on post-employment benefit promises in a short time, the Board decided it would not address all issues relating to the accounting for post-employment benefit promises. In particular, it decided not to address the measurement of post-employment benefit promises generally and not to alter the measurement of typical final salary defined benefit pension plans. Therefore, the Board began by considering the plans to which the requirements of IAS 19 are difficult to apply.

Promises within the scope of the project

4.13 The Board considered the application of IAS 19 to the following promises:

- promises in which any return on contribution is based on the return from an asset, a group of assets or an index
- promises in which the employee has the option to receive the higher of more than one specified return (in other words, the promise includes an embedded option or guarantee).

Asset-based return

4.14 The projected unit credit method is difficult to apply to promises of a return on contributions based on the return on assets or an index (see paragraph 4.9). Some take the view that the projected unit credit method in IAS 19 would require the benefit to be projected forward at an expected rate of return on the assets or index and discounted to a present value using the rate specified in IAS 19. However, unless the benefit is based on the return on high quality corporate bonds, that discount rate would not measure the benefits correctly because the discount rate does not reflect the risk of the assets.

4.15 The Board noted that any specified discount rate would result in a similar problem.

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Benefits that include optionality

4.16 Some promises include an embedded option or guarantee (see paragraph 4.9), for example:

(a) a return linked to an equity index with a guaranteed minimum return of 3 per cent, or

(b) a return that is the higher of 4 per cent and the increase in an inflation index.

4.17 The options or guarantees embedded in such promises have a time value and may have an intrinsic value. An option or guarantee has an intrinsic value when the specified return is greater than the present market return. The projected unit credit method, which does not attribute any value to options or guarantees with zero intrinsic value, can understate the liability, and does not provide information about the existence of those options or guarantees. Thus, the requirements of IAS 19 do not provide useful information about the value of embedded options and guarantees.

Summary

4.18 The method required by IAS 19 does not result in the faithful representation of the liability for the promises described above because the promises depend on the return on assets or indices. Therefore, the Board sought to separate such promises from defined benefit promises that do not include any asset-based risk, and to identify a more appropriate measurement attribute or method for them. In particular, the Board's preliminary view is that a distinction should be made between promises that bear asset-based risk and promises that bear salary risk.

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Chapter 5 Definitions

5.1 This chapter proposes revised definitions for types of post-employment benefit promises, for which the application of IAS 19 has caused particular problems in practice, and discusses the consequences of these definitions.

5.2 Examples of promises with varying characteristics are given below in order to clarify the main features of contribution-based promises that satisfy the proposed definition.

5.3 The Board's preliminary views are:

- The definitions of post-employment benefits and defined benefit plans in IAS 19 should be revised as follows:

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

  A *~~D~~defined benefit promise* is a ~~*plans* are~~ post-employment benefit promise that is not a contribution-based promise ~~plans other than defined contribution plans~~.

- A new definition of contribution-based promises should be introduced as follows:

  A *contribution-based promise* is a post-employment benefit promise in which, during the accumulation phase, the benefit can be expressed as:

  (i) the accumulation of actual or notional contributions that, for any reporting period, would be known at the end of that period, except for the effect of any vesting or demographic risk; and

  (ii) any promised return on the actual or notional contributions is linked to the return from an asset, group of assets or an index. A contribution-based promise need not include a promised return.

- The definitions of post-employment benefit plans and defined contribution plans should be deleted.

5.4 Examples of benefit promises and their classification are discussed below and summarised in Appendix A.

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Definitions of post-employment benefit promises

5.5 Employers may offer post-employment benefit plans that include one or more types of post-employment benefit promises. The IAS 19 definitions address post-employment benefit plans, not promises. However, in the Board's preliminary view, the unit of account should be the promise made to the employee. Accordingly, the Board thought that the definition of post-employment benefit plans should be deleted.

5.6 As a result, in the Board's preliminary view the Board proposes to include a reference to 'formal or informal arrangements' in the revised definition of post-employment benefit promises in paragraph 5.3. If a post-employment benefit promise includes more than one type of benefit promise, the entity should identify and account for each type of promise separately. For example:

Promise 1

The employer promises a benefit equal to:

- for the first 15 years of service, a lump sum accumulated as follows: contributions of 8 per cent of salary for each year of service, with a return on the contributions equal to the return on an equity index.
- for the next 15 years of service, a lump sum equal to 3 per cent of final salary for each year of service.

5.7 This post-employment benefit promise has a contribution-based promise (for the first 15 years) and a defined benefit promise (for the next 15 years). In the Board's preliminary view, the two promises should be accounted for separately.

Definition of defined benefit promises

5.8 In IAS 19, all plans that do not meet the definition of defined contribution plans are defined benefit plans. In the Board's preliminary view, defined benefit promises should remain the default category. In other words, all promises that do not meet the definition of contribution-based promises should be defined benefit promises.

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Definition of contribution-based promises

5.9 In the Board's preliminary view, contribution-based promises should be defined as set out in paragraph 5.3. An example of a contribution-based promise is:

> **Promise 2**
>
> The employer promises to make contributions into a fund of 5 per cent of the employee's salary during the current reporting period for each year of service. The benefit promise at retirement is a lump sum equal to the contributions adjusted for the compound return on a specified equity index.

5.10 The main objective of the definition of contribution-based promises is to separate promises that depend on the return on assets or indices from promises that do not. The following promises are examples of contribution-based promises:

- promises that IAS 19 classifies as defined contribution plans (paragraphs 5.17–5.23)
- promises of a return based on notional contributions (paragraph 5.26)
- promises that guarantee a fixed return on contributions (paragraphs 5.30–5.32), including a fixed return of 0 per cent (paragraph 5.33)
- promises expressed as a fixed lump sum at retirement that is not dependent on service. Such a promise can also be expressed as a single contribution for the first period of service and a 0 per cent return on the contribution.
- career average promises (ie promises based on the average of the employee's salary over his or her entire service period) (paragraphs 5.34–5.48)
- average salary promises based on the average of the employee's salary over past and current service periods (paragraphs 5.44 and 5.45)
- promises that a lump sum will be converted into an annuity at a fixed annuity rate (paragraphs 5.53–5.55)
- promises in which specified amounts that are not dependent on service are paid in regular instalments after retirement (paragraphs 5.57–5.59).

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5.11 Contribution-based promises exclude:

- any promise that includes salary risk (paragraphs 5.38–5.43)
- other post-employment benefit promises, such as typical post-employment life insurance and medical care (paragraphs 5.49–5.51).

Features of contribution-based promises

5.12 The main features of contribution-based promises are that:

- they are characterised by the way in which the benefit is accumulated (paragraphs 5.13–5.16).
- there is no requirement for a promised return but, if a return is promised, it must be linked to the return from an asset, group of assets or an index (paragraphs 5.17–5.25).
- there is no requirement for the promise to be funded (paragraph 5.26).
- the contribution amount is known at the end of the reporting period to which the contribution relates (paragraphs 5.27–5.51), except that
  (a) the definition is independent of vesting conditions (paragraph 5.52).
  (b) the definition is independent of demographic risk (paragraphs 5.53–5.59).

These are discussed in greater detail below.

The definition depends on the accumulation phase

5.13 The definition of a contribution-based promise relies on the way in which the benefit is accumulated.

5.14 Promises made to employees could be viewed as having three phases:

- an accumulation phase, during which the employee renders service in exchange for the promise of remuneration in the future.
- a deferment phase, during which the employee no longer renders service in exchange for benefits, but before the payment of benefits begins.

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- a payout phase during which the employer pays to the employee the previously deferred remuneration.

5.15 Once an employee ceases to accumulate benefits (ie during the deferred and payout phases), the employer's obligation for the benefit due to the employee ceases to depend on the way in which that benefit was accumulated. A pension of CU1,000 payable in annual instalments creates the same obligation regardless of whether it was accumulated as a percentage of salary, as contributions plus a return on an equity index, or as a fixed amount with inflationary increases in the deferment phase.

5.16 In order to isolate most closely the benefits to be addressed in this project, the Board thinks it should base the definition of contribution-based promises (and hence defined benefit promises) on the characteristics of the accumulation phase.

No requirement for a promised return

5.17 The proposed definition of a contribution-based promise does not require a benefit promise to include a promised return. Accordingly, the definition includes promises that are defined contribution plans in IAS 19.

5.18 An example of a contribution-based promise that would meet the IAS 19 definition of a defined contribution plan is:

Promise 3
The employer promises to make contributions into a fund of 5 per cent of the employee's current salary for each year of service. The benefit promise at retirement is a lump sum equal to the contributions paid plus the actual investment returns on those contributions.

5.19 IAS 19 defines defined contribution plans as plans in which:

> ... an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

5.20 Promises that meet this definition also meet the definition of contribution-based promises because the contributions are known at the end of the reporting period to which the contribution relates (see paragraphs 5.27–5.51).

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5.21 The Board acknowledges views that it should not revise the accounting for defined contribution plans because it is straightforward and unproblematic in practice. However, the Board noted there is some confusion about whether the IAS 19 definition of defined contribution plans includes plans that either are unfunded or allow a delay in the payment of the contributions. Delayed payment of contributions introduces a promised return element into the promise, making such promises similar to other contribution-based promises.

5.22 Accordingly, the Board decided that the definition of contribution-based promises should include plans that IAS 19 defines as defined contribution plans.

5.23 Chapter 7 describes the differences between the measurement proposed for contribution-based promises and the measurement required by IAS 19 for plans that IAS 19 defines as defined contribution. Chapter 9 describes the Board's proposals for the disaggregation, presentation and disclosure of contribution-based promises, including the expected effect on plans that IAS 19 defines as defined contribution. Those chapters explain that there are unlikely to be significant differences between current practice and the proposals in this paper for many defined contribution plans.

Promised return linked to the return from an asset, group of assets or an index

5.24 The proposed definition of a contribution-based promise requires the promised return to be linked to the return from an asset, group of assets or an index. For example, a promise of a fixed return on contributions meets the definition of a contribution-based promise because the return on the contributions is linked to the return from an asset, such as a bond with a fixed return.

5.25 However, the definition does not require the promised return to be identical to the return from an asset, group of assets or index that is readily available in an accessible market. The promised return need only be *linked* to the return from such assets, groups of assets or indices. For example:

- a promised return of 100 basis points above a fixed rate bond is linked to the return from that fixed rate bond.
- a promise in which the return for a year is the interest rate on a 30-year fixed rate bond issued in that year is linked to the return from a 30-year fixed rate bond.

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Funding of the contribution amount

5.26 A contribution-based promise specifies, implicitly or explicitly, a contribution amount. In some cases, the employer promises to pay contributions into a separate fund in each period of service (actual contributions). In other cases, the employer may not fund the contributions (ie the contributions are notional), or may specify that the contributions will not be paid until some time in the future. The proposed definition of a contribution-based promise does not require an employer to pay the contributions to a fund in any particular period. An example of a promise in which the contributions are notional is:

Promise 4
The employer promises to make notional contributions of 5 per cent of the employee's current salary for each year of service. The benefit promise at retirement is a lump sum equal to the notional contributions plus interest compounded at the rate of each year's return on a specified equity index.

Contribution known at the end of the reporting period to which the contribution relates

5.27 The definition of a contribution-based promise requires that the contribution for any period of service is known at the end of that period, except for the effect of any vesting or demographic risks.

5.28 This requirement means the risks in the accumulation phase of a contribution-based promise are limited to asset-based risks primarily.[*] In particular, it excludes from the definition promises with salary risk. The Board developed this aspect of the definition as a result of coming to the following conclusions:

- The accounting for typical final salary promises should not change.
- A promise that the employee will receive a promised fixed return on contributions is a contribution-based promise.

[*] There may also be vesting risk and some demographic risks, but these should be less significant. See paragraphs 7.20–7.22.

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- The following post-employment benefit promises should be accounted for in the same way because they are identical economically:
  - (i) a promise in which the benefit is accumulated through notional contributions expressed as a percentage of current salary for each year of service and a promised fixed return of 0 per cent.
  - (ii) a career average promise in which the benefit is a lump sum benefit equal to the same percentage of the career average of the employee's salary for each year of service.
- Other post-employment benefit promises, such as post-employment life insurance and post-employment medical care, should continue to be accounted for as defined benefit promises.

5.29 Paragraphs 1.4–1.7 explain that the scope of this project does not include the accounting for typical final salary promises. Paragraphs 5.30–5.51 discuss the reasons for the Board's other conclusions above and their consequences.

Promised fixed returns

5.30 An example of a promise of a fixed return on contributions is:

Promise 5
The employer promises to make notional contributions of 5 per cent of the employee's current salary for each year of service. The benefit promise at retirement is a lump sum equal to the contributions plus a fixed return of 3 per cent per year on the contributions.

5.31 The Board considered views that benefits that include a fixed return should not be within the scope of this project, and thus should remain classified as defined benefit. There are no particular problems in applying the measurement requirements of IAS 19 in projecting forward the benefit of a fixed return. IAS 19 requires an entity to make an estimate of the amount of benefit that employees have earned in return for their service to date. That benefit can be calculated by projecting forward the contributions at the promised fixed rate of return.

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5.32 However, the Board decided that all promises that include a promised return linked to the return on an asset should be contribution-based promises. There is no conceptual basis to separate promises of a fixed return from promises of a variable return. The distinguishing feature of contribution-based promises is that they promise a benefit based on a return on contributions that is linked to the return on an asset (or assets) or an index.

Promises of fixed return of 0 per cent and career average promises

5.33 Promises of fixed returns include promises in which the fixed return is 0 per cent. A fixed return of 0 per cent means that an employee is not exposed to the risk that the accumulated value of his investments might decrease. For example:

Promise 6
The employer promises to make notional contributions of 5 per cent of the employee's current salary for each year of service. The benefit at retirement is a lump sum equal to the contributions plus a fixed return of 0 per cent per year on the contributions.

5.34 The Board noted that a promise of a fixed return of 0 per cent is the same as a career average salary promise, such as Promise 7:

Promise 7
The benefit is a lump sum at retirement equal to 5 per cent of the career average of the employee's salary for each year of service.

5.35 Promise 6 and Promise 7 provide the same benefit when an employee leaves service. This is illustrated in Appendix B. Promise 6 is expressed as a current salary promise with a promised fixed return of 0 per cent on contributions. Thus, Promise 6 is a contribution-based promise.

5.36 Some think that Promise 7 should not be a contribution-based promise because it is expressed in a way that depends on the employee's future salary. However,

- the contributions during the accumulation phase can be expressed as the accumulation of actual or notional contributions that are known, except for the effect of any vesting and demographic risks, at the end of the reporting period to which the contribution relates.

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- the only difference between Promise 6 and Promise 7 is the way in which the benefit formula is expressed. The accounting for post-employment benefit promises should not depend on how the employer describes the promise. Thus, career average promises and current salary promises with a fixed return of 0 per cent should be accounted for in the same way.

5.37 Thus, Promise 7 is also a contribution-based promise.

Career average promises and typical final salary plans

5.38 The Board's preliminary view is that it should not change the accounting for typical final salary promises in this project. Accordingly, promises such as Promise 8 will continue to be defined benefit:

> **Promise 8**
>
> The benefit is a lump sum at retirement equal to 5 per cent of the employee's final salary at retirement for each year of service.

5.39 The Board considered how to classify promises based on the average of the employee's salary in the final years of service. An example is:

> **Promise 9**
>
> The benefit is a lump sum at retirement equal to 5 per cent of the average of the employee's final three years' salary before retirement, for each year of service.

5.40 The Board noted that it is not possible to draw a distinction between averaging the last year of salary (Promise 8) and averaging the last three years' salary (Promise 9). IAS 19 and SFAS 87 support this view: in both those standards, Promise 8 and Promise 9 are classified as defined benefit. In the Board's preliminary view, promises based on the average of the employee's salary in the final years of service should remain classified as defined benefit. If the benefit were expressed in terms of a contribution amount and a promised return, the contribution amounts would not be known at the end of the reporting period to which they relate.

5.41 However, some extend this view to promises based on the average of the employee's salary over the whole service period, such as Promise 7. But, as described in paragraphs 5.33–5.37, in Promise 7, the contribution amounts would be known at the end of the reporting period to which they relate. In fact, Promise 7 is the same as Promise 6 and thus should be a contribution-based promise.

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5.42 The Board noted that promises based on average salary over the whole service period (such as Promise 7) and promises that are similar to final salary promises because they are based on average salary over the final years of service can be distinguished as follows. The latter, such as Promise 8 and Promise 9, expose the employer to salary risk. In other words, the benefit cannot be expressed without reference to future salaries. In contrast, career average promises and promises of a fixed return of 0 per cent based on current salary can be expressed without reference to future salaries, and thus do not expose the employer to salary risk.

5.43 Accordingly, the definitions reflect that:

(a) promises that expose the employer to salary risk are not contribution-based, and thus are defined benefit; and

(b) promises that do not expose the employer to salary risk, but only asset-based risk, are contribution-based.

Other promises based on average salary that do not expose the employer to salary risk

5.44 Some promises are expressed in terms of the average of an employee's salary in the current period and in periods before the period in which the contribution is due. An example is Promise 10:

> **Promise 10**
>
> The employer promises to make contributions into a fund for each year of service. The contribution in each year of service is 5 per cent of the average of the employee's salary in the most recent two years of service. The benefit promise at retirement is a lump sum equal to the contributions paid.

5.45 In Promise 10, the contribution for each year of service is expressed in terms of salary relating to past and current periods of service. Thus, it is known at the end of the reporting period to which the contribution relates. The return on the contributions is 0 per cent. Thus, Promise 10 is a contribution-based promise. A contrast can be drawn with Promise 11:

> **Promise 11**
>
> The benefit is a lump sum benefit at retirement equal to the number of years' service multiplied by 5 per cent of the average of the employee's salary in the most recent (ie final) two years of service.

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5.46 In Promise 11, the benefit for a period cannot be expressed in terms of a contribution that is known at the end of the period. The contribution depends on the average salary in the final two years of service. Thus, Promise 11 is not a contribution-based promise and so is a defined benefit promise.

Approaches rejected

5.47 The Board considered views that excluding promises that include salary risk from the definition of contribution-based promises would result in a bright line between contribution-based and defined benefit promises. The Board observed that drawing a line somewhere was a necessary consequence of examining the accounting for only some promises as part of the project. Distinguishing promises based on salary risk draws an objective distinction between current salary/career average promises and average final salary promises and does not require different accounting for economically identical promises.

5.48 The Board also considered and rejected the following approaches:

- classifying as defined benefit all promises based on average salary, including career average promises and current salary promises. The Board rejected this approach because there is no conceptual basis for separating promises of a fixed return from promises of a variable return (see paragraph 5.32).
- classifying as defined benefit all promises described as based on average salary, including career average promises, and classifying as contribution-based all promises described as based on current salary. The Board rejected this approach because it would result in different accounting for economically identical promises, depending on how they are described (see paragraphs 5.33–5.37).
- classifying as contribution-based all promises based on the average salary in the final years of an employee's career. The Board rejected this approach because it did not want to change the accounting for typical defined benefit promises in this project.

Other post-employment benefit promises

5.49 It is outside the scope of this project to consider the accounting for other post-employment benefit promises, such as post-employment life insurance and post-employment medical care. IAS 19 classifies such benefits as defined benefit.

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5.50 The Board noted that such promises can be expressed as an arbitrary contribution with a return guaranteed to generate at retirement the future market price of the cost of the life insurance or medical care. However, that return is not linked to changes in the return on an asset, group of assets or an index. Thus, such promises would not meet the definition of a contribution-based promise.

5.51 Alternatively, the promise can be expressed as a single contribution at the start of the employee's service period with a 0 per cent fixed return. The value of the contribution is equal to the forward price of the life insurance or medical care. The definition of a contribution-based promise requires the contribution to be known at the end of the reporting period to which that contribution relates. Therefore, benefits expressed as a contribution equal to the forward price of the life insurance or medical care do not meet the definition of contribution-based.

Definition independent of vesting conditions

5.52 The definition of contribution-based promises applies to vested and unvested benefits. This follows from the Board's decision to treat unvested contribution-based promises in the same way as vested contribution-based promises in this project (see paragraphs 6.3–6.5). In other words, an unvested promise is contribution-based if, all other things being equal, the promise would have met the definition of a contribution-based promise had the contribution amounts vested at the reporting date.

Definition independent of demographic risk

5.53 Demographic risk is the risk that the liability for benefits promised to a group of beneficiaries will fluctuate because of changes in the characteristics of the members of that group. For instance, longevity risk is the risk that the liability increases because beneficiaries live for longer than expected. The Board considered whether longevity and other demographic risks should affect the classification of a benefit promise. The main reason for amending IAS 19 to address the accounting for contribution-based promises was to resolve problems with the application of the projected unit credit method in IAS 19 to promises that included a promised return on contributions. If demographic risk were to preclude classification as contribution-based of a benefit promise, then the accounting for promises that included a promised return on contributions *and* demographic risk would not be resolved. This would

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mean that the problem with the application of the projected unit method would not be resolved for a significant number of promises. Accordingly, the Board decided that demographic risk should not affect the classification of a benefit promise.

5.54 This conclusion means that contribution-based promises include promises in which the benefit formula at retirement specifies a fixed annuity conversion rate applied to the accumulated lump sum at retirement. Examples of such a promise include:

Promise 12

The employer promises to contribute into a separate fund 5 per cent of the employee's salary for each year of service. The lump sum at retirement, which is equal to the accumulated contributions plus the investment returns they earn, is converted into a pension at a fixed annuity rate (ie the cost of buying a pension is fixed when the promise is made, rather than being determined by the market rates at retirement date). That pension amount is payable in monthly instalments for the life of the retired employee.

Promise 13

The employer promises to contribute CU100,000 into a separate fund on the first day of service. The lump sum at retirement is the contribution of CU100,000 plus a fixed return of 0 per cent. The lump sum is converted into a pension at a fixed annuity rate (ie the cost of buying a pension is fixed when the promise is made, rather than being determined by the market rates at retirement date). This generates a benefit of CU1,000 per year for the life of the retired employee.

5.55 In Promise 12, the promised return is not solely linked to the investment return on the fund, but also includes a component linked to longevity risk. It meets the definition of a contribution-based promise because:

(i) the amount of the contribution of 5 per cent of the employee's current salary is known at the end of the reporting period to which the contribution relates, except for vesting and demographic risks; and

(ii) the return on contributions is linked to the investment return in the fund, and thus to the return from a group of assets.

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5.56 Promise 13 is a contribution-based promise because it includes a lump sum accumulated through a single contribution of CU100,000, and a promised return of 0 per cent. This is then converted to a pension using a fixed annuity conversion rate. Promise 13 is similar to Promise 12 because both include a fixed annuity conversion rate applied to a lump sum accumulated through contributions and a promised return. In Promise 12, the promised return is linked to the investment return on the contributions. In Promise 13, the promised return is fixed at 0 per cent.

Promises in which specified amounts that are not dependent on service are paid in regular instalments after retirement

5.57 The Board noted that promises in which specified amounts that are not dependent on service are paid in regular instalments after retirement are identical to promises such as Promise 13. For example:

> **Promise 14**
>
> The employer promises a benefit of CU1,000 per year for each year after the employee retires until his death, regardless of the service period of the employee.

5.58 Some think that Promise 14 is a defined benefit promise because the only specified parameters are the benefits received each year in the payment phase. Additionally, Promise 14 is not expressed in terms of the accumulation of contributions and a promised return. Accordingly, those holding this view contend that entities should classify Promise 14 as a defined benefit promise.

5.59 However, the Board thinks that entities should account for identical benefits in the same way, regardless of the way in which they are described. Accordingly, the Board decided that entities should classify Promise 14 as contribution-based.

Benefit promises with more than one outcome

5.60 A benefit promise may specify more than one benefit event. For example, a benefit promise may specify that an employee will receive different types of benefits depending on the benefit event that triggers payment of the benefit. For example, an employer may promise an employee a defined contribution benefit if the employee survives to retirement, or a defined benefit death in service widow's pension if the employee dies before retirement. In this case, the employee has the possibility of

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receiving different benefits for different events. The accounting for the option to receive different benefits for different types of benefit events is outside the scope of this project. The Board could not address these promises in this project and meet its intended timetable.

5.61 A benefit promise may also specify more than one amount for the same benefit event. For example, a benefit promise may specify that an employee will receive a benefit that offers the option of receiving the higher of two or more amounts for any single benefit event. For example, an employer may promise an employee a lump sum at retirement equal to the value of the accumulation of contributions plus the actual investment returns on those contributions, or a specified amount, whichever is higher. In this case, the employee has the option to receive the 'higher of' two amounts when a specified benefit event occurs. The accounting for such 'higher of' options is discussed in Chapter 10.

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Chapter 6 Recognition issues relating to contribution-based promises

6.1 This chapter discusses issues relating to the recognition of contribution-based promises, in particular:

- the recognition of unvested benefits.
- the allocation of benefits.
- whether an employer should recognise an additional liability when it would be required to pay an employee who leaves service immediately after the reporting date more than the amount that it would otherwise recognise as its liability at the reporting date.

6.2 The Board's preliminary views are:

- Unvested contribution-based promises should be recognised as a liability.
- Benefits from a contribution-based promise should be allocated and recognised in accordance with the benefit formula.
- There should be no requirement to recognise an additional liability to reflect the amount that an employer would have to pay an employee who leaves service immediately after the reporting date.

Unvested benefits

6.3 Some benefit promises are subject to vesting conditions. In other words, the employees will not receive any benefits unless they satisfy specified conditions, usually relating to length of service. IAS 19 does not discuss how vesting conditions affect defined contribution plans. For defined benefit plans, the Basis for Conclusions on IAS 19 states that 'an entity has an obligation under a defined benefit plan when an employee has rendered service in return for the benefits promised under the plan' (paragraph BC13) and notes that 'an obligation exists even if a benefit is not vested'(paragraph BC14). Accordingly, IAS 19 treats unvested defined benefit promises as liabilities.

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6.4 The conclusion that unvested benefits are a liability has been the subject of debate. Some think that unvested benefits represent a constructive obligation in IAS 37 and thus meet the definition of a liability. Others think that no *present* obligation exists for unvested benefits, or that no obligation exists because the employer can take action to avoid the outflow of economic resource, eg by terminating the employee's contract before the benefits vest.

6.5 The question of whether unvested benefits are a liability is outside the scope of this project (see Chapter 1). The Board decided not to address this question about benefit accounting by drawing conclusions that apply only to contribution-based promises. Therefore, in this project, the Board treats unvested contribution-based promises as a liability, consistently with the requirements of IAS 19.

Benefit allocation

6.6 The Board considered when the liability for a contribution-based promise should be recognised. IAS 19 requires the recognition to be based on an allocation of benefits according to the benefit formula, except for some defined benefit plans (discussed below).

6.7 The Board decided that the scope of this project precludes changing IAS 19's general reliance on the benefit formula to determine the liability recognised for post-employment benefit promises.

6.8 However, the Board considered whether departure from the benefit formula should be required if the formula assigns materially higher benefits to later periods of service. When this happens, following the formula would mean that entities would recognise a higher expense in later years than in earlier years. In these circumstances, IAS 19 requires:

- no departure from the benefit formula for defined contribution plans. For example, if a defined contribution plan promised a benefit of contributions of 5 per cent of current salary for the first ten years of service and 10 per cent for the next ten years, the fact that the benefits earned in later periods are higher than the benefits earned in early periods would not affect the accounting. Entities would not make an accrual in the early periods for the higher benefits to be earned in the later periods.
- entities to allocate the total benefits in a defined benefit plan on a straight-line basis over the periods of service. In other words, the

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allocation of benefits for some defined benefit plans does not follow from the benefit formula.

6.9 The Board decided not to allow entities to depart from the benefit formula in these circumstances for contribution-based promises for the following reasons:

- Allowing or requiring it would complicate the measurement. In Chapter 7, the Board's preliminary view is that entities should measure a contribution-based promise at fair value assuming the terms of the benefit promise do not change. It is not meaningful to calculate the fair value of an allocated amount.
- Not allowing it would result in promises that meet the definition of defined contribution in IAS 19 being accounted for as required by the existing version of IAS 19.

Recognition of an additional liability

6.10 IAS 39 *Financial Instruments: Recognition and Measurement* states that:

> The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.*

6.11 Chapter 7 discusses a measurement based on fair value for contribution-based promises. The Board considered whether a similar minimum fair value to that required in IAS 39 should apply to the measurement of contribution-based promises. Such a requirement would result in entities recognising an additional amount determined by the benefit that an employer would have to pay when an employee leaves employment immediately after the reporting date. This benefit is likely to be greater than the present value of the benefit payable when the employee is expected to leave service if the benefit vests immediately and the rate of return promised to the employee is less than the discount rate used to determine the present value.

6.12 The Board decided that an entity should not recognise an additional amount determined by the benefit that an employer would have to pay when an employee leaves employment immediately after the reporting date because:

- IAS 19 does not require recognition of an additional liability for other post-employment benefit promises. Paragraphs BC63–BC65

* Paragraph 49 of IAS 39

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of the Basis for Conclusions on IAS 19 state that IASC considered but rejected a requirement to recognise an additional minimum liability in these circumstances. IASC concluded that 'such additional measures of the liability are confusing and do not provide relevant information. They would also conflict with the *Framework*'s going concern assumption and with its definition of a liability.'

- it would result in different accounting depending on whether the benefits were vested or unvested. The additional amount in question can arise only for vested benefits. The Board decided to preserve consistent accounting for vested and unvested benefits in this project.

Recognition of benefits earned in future periods

6.13 A contribution-based promise may include a promise that a specified return will apply to benefits that will be earned in future periods. In the Board's preliminary view, entities should not recognise a liability for benefits or returns on benefits that will be earned in future periods. The entity has no present obligation to pay those benefits.

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Chapter 7 Measurement of contribution-based promises – core issues

7.1 This chapter discusses the characteristics that the Board seeks in the measurement of contribution-based promises. The Board considered the following:

- identifying the unit of account.
- selecting a measurement attribute.
- implications for plans that IAS 19 currently classifies as defined contribution plans.

7.2 In the Board's preliminary view, an entity should measure its liability for a contribution-based promise at fair value assuming the terms of the benefit promise do not change. This chapter describes the rationale for this preliminary view.

Identifying the unit of account

7.3 A contribution-based promise can be divided into two components:

- a contribution amount
- a promised return (if any).

7.4 The Board considered whether entities should measure separately the two components of a contribution-based promise. Some think that the contribution component in a contribution-based promise is similar to a defined contribution plan in IAS 19. Accordingly, the Board considered whether the contribution amount should be measured in the same way as a defined contribution plan is measured in IAS 19. In that case, the Board would only need to consider a measurement attribute for the promised return, which does not exist in defined contribution plans in IAS 19.

7.5 However, any approach that measured the liability for the contribution amount differently from the promised return could lead to the same economic obligation being accounted for differently. For example, assuming the benefits vest in five years, the following promises are economically identical:

- a promised lump sum of CU1,340 paid in five years (ie a contribution of CU1,340 plus a fixed return of 0 per cent); and

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- a promised lump sum of CU1,000 plus a fixed return of 6 per cent per year paid in five years.

7.6 Applying different measurement bases to the contribution amount and the promised return would result in a different measurement of the liability, depending on how it is described. This provides opportunity for accounting arbitrage. Accordingly, the Board concluded that there should be a single measurement basis for the contribution amount and the promised return. In other words, the unit of account is the entire contribution-based promise.

Selecting a measurement attribute

7.7 The Board's objective is to select a measurement attribute for a contribution-based promise that gives users of financial statements useful information about the amount, timing and uncertainty of future cash flows resulting from that promise. The Board thinks that a measurement approach that includes the following characteristics would meet that objective:

- an estimate of the future cash flows
- the effect of the time value of money
- the effect of risk.

7.8 Measurement attributes exhibit these characteristics in different ways. For example, cash flow estimates may be current or historical, discounting may be incorporated explicitly, and an explicit or implicit allowance for risk may be included. Paragraphs 7.9–7.35 consider how, and to what extent, each characteristic should be included in the measurement of a contribution-based promise. Paragraphs 7.36–7.40 draw together the Board's preliminary views on how each characteristic might be incorporated to achieve a useful measurement attribute for contribution-based promises.

Estimate of cash flows

Overall objective for estimates of cash flows

7.9 Paragraph 7.7 identifies the characteristics that the Board thinks should be incorporated in the measurement of a post-employment benefit liability. The first characteristic is an estimate of the future cash flows arising from the benefit obligation. As with IAS 19, the Board intends to

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give high level guidance on the estimation of such cash flows, but not detailed guidance, such as might be found in an actuarial textbook. In summary, the Board's preliminary view is that in measuring benefit liabilities, an entity should make estimates of future cash flows that:

(a) are explicit;

(b) are as consistent as possible with observable market factors;

(c) incorporate, in an unbiased way, all available information about the amount, timing and uncertainty of all cash flows arising from the obligation; and

(d) are current, in other words they correspond to conditions existing at the end of the reporting period.

Explicit estimates

7.10 Some think that estimates of cash flows should be explicit in all cases. IAS 19 requires explicit assumptions to be made of the variables underlying the cost of defined benefit promises. Others think that explicit estimates are not needed if the overall measurement of the liability is such that it is unlikely that the actual cash flows will exceed that measurement. However, in the Board's preliminary view, explicit estimates result in a more faithful representation of the claims of employees on the resources of the entity. The resulting information is more relevant to users, more understandable and more comparable with information produced by applying IFRSs to other liabilities, in particular non-financial liabilities (IAS 37).

Consistency with observed market prices

7.11 Some inputs used to estimate cash flows relate to observable market variables. For example, when a contribution-based promise includes a return that depends on the performance of an equity index, the value of that index reflects market expectations of future cash flows. Some think that an entity should substitute its own estimate of those variables if the entity thinks other evidence is more persuasive than the observed rates or prices. Some also think that short-term fluctuations in market prices are of limited relevance for long-duration contracts that entities generally do not (and cannot) transfer to a third party.

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7.12 However, the Board's preliminary view is that measurements are more relevant and reliable if they are consistent with observed market factors, because such measurements:

- involve less subjectivity than measurements that use the entity's own estimates.
- reflect all evidence available to market participants.
- are developed using a common and publicly accessible benchmark that users can understand more easily than information developed using a private internal benchmark.

7.13 Therefore, the Board's preliminary view is that the inputs used to develop estimates of cash flows should, as far as possible, be consistent with observed market factors. In other words, an entity would use observable current market variables, such as the value of an equity index, as direct inputs without adjustment.

Unbiased use of all available information

7.14 The cash flows associated with a contribution-based promise are uncertain. In other words, more than one outcome is possible. Some think that a measurement of a benefit liability should use a single estimate of the cash flows, such as the most likely outcome. This is the approach in IAS 19 for defined benefit promises.

7.15 However, a measurement of a contribution-based promise liability is most useful if it captures information about the full range of possible outcomes and their probabilities because it provides more information about the possible variability in cash flows.

7.16 In the Board's preliminary view, the measurement of a contribution-based promise liability should be based on an expected value approach. The expected present value is the probability-weighted average of the present value of the cash flows. This approach considers all possible outcomes.

7.17 Estimates of the probabilities associated with each cash flow scenario should be neutral. In other words, they should not be biased with the intention of attaining a predetermined result or inducing particular behaviour. Neutrality is essential because biased financial reporting information cannot faithfully represent economic phenomena. Among other things, neutrality requires estimates of cash flows and the associated probabilities to be neither conservative nor optimistic.

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Current estimates

7.18 IAS 19 requires the measurement of defined benefit liabilities to be based on current estimates of cash flows. The Board's view is that entities should use current estimates for the measurement of contribution-based promises for the following reasons:

- They give a more faithful representation of the entity's obligations and convey more useful information about the amounts, timing and uncertainty of the cash flows generated by those obligations and rights. Given the uncertainty associated with a promised return, and the long duration of many contribution-based promise liabilities, current information about the amount, timing and uncertainty of cash flows is relevant for users.
- They require an entity to consider whether circumstances have changed.
- The measurement incorporates all available information.
- Their use is consistent with other IFRSs for non-financial liabilities (IAS 37) and some financial liabilities (IAS 39). Both IAS 37 and IAS 39 require measurements based on current estimates of future cash flows.
- Their use reduces possible accounting mismatches between contribution-based liabilities and plan assets, and should highlight economic mismatches.

Time value of money

7.19 IAS 19 requires discounting for defined benefit liabilities and defined contribution liabilities that are due more than twelve months after the reporting date. The Board's preliminary view is that the time value of money should also be included in the measurement of contribution-based promises. As with the estimates of cash flows, a current measure of the time value of money should be used.

The effect of risk

7.20 The objective of including the effect of risk in the measurement of a contribution-based promise liability is to convey decision-useful information to users about the uncertainty associated with future cash flows.

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7.21 For post-employment benefit promises, the effect of risk on the liability cannot be observed because typical benefit arrangements have no initial transaction price with which to calibrate the cash flow estimates. However, an adjustment for the effect of risk is needed because there would otherwise be no difference between a liability with fixed future cash flows and one with uncertain future cash flows with the same expected return. Some hold the view that no risk adjustment is needed for factors that are uncorrelated with changes in the value of market assets (diversifiable risk). The Board has not yet discussed this view or its implications for the measurement of contribution-based promises.

7.22 The Board noted that contribution-based promises do not expose the employer to some of the risks that are common in typical defined benefit promises. For example, a contribution-based promise does not expose the entity to salary risk (because the benefit for current and prior periods is not affected by future increases in salary). The Board identified the main risks in a liability resulting from a contribution-based promise as:

- asset-based risk, ie the risk that the liability for benefits promised will fluctuate because of changes in the value of the assets or indices. Asset-based risk is similar to market risk for financial instruments.*
- demographic risk, in particular longevity risk. However, for many contribution-based promises, the benefit at retirement is a lump sum, or an annuity set at market rates. In these cases, longevity risk would not be significant during the accumulation phase.
- credit risk, ie the risk that the entity would be unable to make the necessary payments.
- risk that the terms of the benefit promise change.

Asset-based risk

7.23 Inclusion of an appropriate measure of the effect of asset-based risk is one of the main improvements that the Board wishes to make to the measurement of contribution-based promises. The Board thinks that often the effect of asset based risk can be determined by reference to observable market prices of similar assets.

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* Market risk is defined as 'The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices.'

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7.24 Accordingly, the Board's preliminary view is that the effect of asset-based risk should be included in the measurement of a contribution-based promise liability.

Demographic risk

7.25 As noted in paragraph 7.22 the Board thought that demographic risks would be less significant than asset-based risks for many contribution-based promises. Nevertheless, the Board's preliminary view is that, when such risk is present, its effect is relevant information that should be included in the measurement of contribution-based promises.

Credit risk

7.26 The Board considered whether to reflect credit risk in the measurement of a contribution-based promise. Credit risk is, generally, the risk that one party to a financial instrument will cause a financial loss for the other party. More specifically, for a contribution-based promise, it is the risk that the assets available to meet the benefit promise, including both plan assets, if any, and the entity's assets, would be insufficient, thus causing the entity to be unable to make the necessary payments. Credit risk could have a significant effect on the measurement of entities' liabilities for benefits for past service.

7.27 In principle, the Board thinks that the effect of the credit risk of a liability is relevant information that should be included in its measurement.

7.28 However, the Board notes that including the credit risk specific to the contribution-based promise would be a significant change and could be difficult to do for the following reasons:

- The initial exchange of services for post-employment does not provide a readily observable price for the risk.
- The credit risk of the contribution-based promise may be affected by other liability-specific matters, such as any funding of the promise. Contribution-based promises are unlikely to have specific issue credit ratings and the necessary adjustments to an entity credit rating may be difficult to establish.

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7.29 The Board noted that these issues also apply to the measurement of some other liabilities for which the entity is required to take credit risk into account. Therefore, the Board did not think that the issues raised in paragraph 7.28 are a sufficient justification for excluding credit risk from the measure of the liability for contribution-based promises. However, the Board is interested in hearing views on how any practical issues might be resolved.

Risk that the terms of the benefit promise change

7.30 The Board considered whether to reflect, in the measurement of the liability for a contribution-based promise, the risk that the terms of the benefit promise change.

7.31 The terms of the benefit promise may change for a number of different reasons. For instance, there may be a statutory change or a change in industry practice.

7.32 The Board noted arguments that the measure of the liability should take into account all possible future events, including the possibility that the entity decides to change the terms of the benefit promise. However, the Board's view was that to do so would misrepresent the nature of the entity's obligation. The Board thought that the unit of account should be the benefit promise that has been made, not a benefit promise that might exist in the future. The measurement of that item should include the possibility that the entity may be unable to make the payments necessary but should not include changes to the item itself. The former is the credit risk for the liability for the benefit promise, the latter is not.

7.33 Therefore, the Board concluded that contribution-based promises should be measured on the basis of the assumption that the terms of the benefit promise will not change.

Summary of the Board's preliminary view on the measurement of contribution-based promises

7.34 The Board's preliminary view is that the measurement of an entity's liability for a contribution-based promise should incorporate the following characteristics:

- explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows.
- current market discount rates that adjust the estimated future cash flows for the time value of money.

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- the effect of risk, other than the risk that the terms of the benefit promise change.

7.35 In the Board's view, a measurement that includes those characteristics provides several benefits to users of an entity's financial statements:

- It includes relevant information about the amount, timing and uncertainty of future cash flows arising from a promised return. Given the uncertainty associated with post-employment benefit promises and the long duration of many promises, such information is important.
- It provides consistency with other IFRSs that require current estimates of future cash flows in measuring non-financial liabilities (see IAS 37) and financial liabilities (see IAS 39).
- There is no need to separate embedded options and guarantees because the measurement includes a market-consistent estimate of both their intrinsic value and their time value. If features of the embedded options or guarantees are interdependent, separating them may be arbitrary and costly.
- It is consistent with observable current market prices, to the extent they are available. Such prices provide a more understandable and credible benchmark for users, even though market prices are not available to support all inputs used in measuring contribution-based liabilities.

Identifying the measurement attribute

7.36 A measurement attribute that exhibits the characteristics in paragraph 7.34 will be most helpful to users if it represents faithfully a real-world economic attribute of the liability being measured. Assets and liabilities have various attributes, such as cost, depreciated cost, amortised cost or various forms of current value, such as fair value. The attribute used in the financial statements is sometimes described as the measurement attribute.

7.37 The Board did not consider cost-based attributes for the measurement of contribution-based promises. Cost-based attributes cannot be readily observed for transactions between entities and employees because the cost of providing the benefit to employees for a period is the service provided by employees during that period. In addition, cost-based attributes do not use current estimates of all the information available.

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7.38 The Board noted that a contribution-based promise is similar to a contract that includes a derivative because there is a wide variability in the future cash flows required to settle the liability. IAS 39 requires derivatives to be measured at fair value. The Board noted that fair value is a measurement attribute that incorporates the characteristics that the Board seeks for measurement and represents faithfully an attribute of a contribution-based promise liability. It is a measurement attribute with which users of IFRSs are familiar and is defined as 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction'.

7.39 The Board concluded that a clear and concise way of expressing the Board's desired measurement is *fair value assuming the terms of the benefit promise do not change*. The application of this measurement attribute is illustrated in the examples below.

Example 1

An employer promises to pay at retirement a contribution of CU1,000 and a market total equity return per year on that contribution until the employee retires. The benefit vests on the first day of service. The fair value of that promise, assuming the terms of the benefit promise do not change, would include the effect of credit risk and may, therefore, be less than CU1,000.

Example 2

An employer promises to pay at retirement a contribution of CU1,000 and a fixed return of 4 per cent per year until the employee retires. The contribution vests on the first day of service. The fair value of the promise, assuming the terms of the benefit promise do not change, is CU1,000 plus the compound effect of 4 per cent per year discounted at a rate that reflects the credit risk specific to the promise.

7.40 The Board acknowledges that *fair value assuming the terms of the benefit promise do not change* may not be fair value. This is a question that will be addressed in the fair value measurement.

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Implications for plans that IAS 19 classifies as defined contribution plans

7.41 The Board does not intend to change significantly the accounting for most post-employment benefit plans that IAS 19 classifies as defined contribution plans. IAS 19 requires the liability for a defined contribution plan to be measured as unpaid contributions, discounted using a high quality corporate bond rate if they are not wholly due within twelve months after the end of the period in which the employees render service.*

7.42 A promise that is classified as a defined contribution plan in IAS 19 is a contribution-based promise. The proposal that the contribution amount should be measured at fair value assuming the terms of the benefit promise do not change would cause a change in accounting because any unpaid contributions could be discounted at a rate different from a high quality bond rate.

7.43 However, if a promise is classified as defined contribution in IAS 19 and the entity pays the contributions soon after the period to which they relate, the effect of the change in measurement is likely to be insignificant. The Board thinks that this will be the case for many promises that are classified as defined contribution in IAS 19.

* Paragraph 45 of IAS 19 requires that 'Where contributions to a defined contribution plan do not fall due wholly within twelve months after the end of the period in which the employees render the related service, they shall be discounted using the discount rate [for a high quality corporate bond].'

Chapter 8 Measurement of benefits after the accumulation phase

8.1 The definitions of contribution-based promises and defined benefit promises rely on the nature of the benefit promise during the accumulation phase. After the employee ceases to accumulate benefits, the liability to pay benefits does not depend on the way in which that liability arose. This chapter discusses the measurement of the obligation to pay benefits after the accumulation phase.

8.2 The Board's preliminary view is that an entity should measure the liability for benefits in the payment and deferment phases in the same way as in the accumulation phase.

Benefits in payment

8.3 When the benefits are in the payment phase, the employer settles its liability for previously deferred payments to the employee. It may do this in one of the following ways:

(a) a payment of a lump sum to the employee. For contribution-based promises, the lump sum comprises the contributions plus the returns on those contributions up to the date of retirement.

(b) purchase of an annuity at market rates (eg from an insurance company) to the value of the contributions plus the returns on those contributions up to the date of retirement. The purchase of such an annuity settles the employer's liability to make regular payments until a specified time, usually the employee's death. From the employer's point of view, this is economically the same as (a) above.

(c) regular payments until a specified time, usually the employee's death (an annuity). Those regular payments could be:

(i) based on market annuity rates at the date of the employee's retirement;

(ii) based on an annuity rate other than the market rate at the date of the employee's retirement; or

(iii) based on some other factor such as 50 per cent of the full career average of salary.

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8.4 If an employer settles its obligation through a lump sum payment or the purchase of an annuity, the employer extinguishes its liability and has nothing left to account for. In contrast, if the employer is obliged to make a stream of payments to the employee (and does not settle its obligation through the purchase of an annuity), the employer has an ongoing liability to account for.

8.5 The same ongoing obligation could arise from different methods of accumulation. For example:

> **Promise A** is a contribution-based promise in which the contributions plus the investment returns are converted to an annuity at a guaranteed rate. At retirement, Promise A results in the employee's entitlement to receive CU100 per year after retirement.
>
> **Promise B** is a defined benefit promise in which the employee is entitled to annual payments after retirement of 50 per cent of his final salary. The employee's final salary at retirement is CU200. Thus, the employee is entitled to receive CU100 per year after retirement.

8.6 In both Promise A and Promise B, the employer is obliged to pay CU100 per year until the employee dies, unless it settles the obligation. If the employees have the same life expectancy, the liability for Promise A should be the same as for Promise B. However, at the beginning of the payment phase, the employer would have recognised the following liabilities:

- For Promise A, the liability would be the price in the market for an annuity of CU100 per year adjusted for credit risk.
- For Promise B, the liability would be CU100 per year, with no risk margin, discounted at a high quality corporate bond rate.

Thus, the liability at retirement would be measured differently for Promise A and Promise B, even though the obligation is the same, ie to pay CU100 per year until the employee dies.

8.7 The Board considered whether it should require:

- the measurement of Promise A and Promise B to be the same after retirement. This would mean that there is only one measurement for identical obligations, but it would result in the need to recognise a gain or loss for either Promise A or Promise B at the date of retirement.

- the measurement of Promise A and Promise B to be consistent with the measurement in the accumulation phase. This would result in different amounts for economically identical promises.

8.8 The Board thinks that the same obligation should be accounted for in the same way. However, the Board also thinks that an obligation should be accounted for consistently throughout its life. The Board acknowledges that these two beliefs are incompatible in the above examples. The Board is unable to resolve the contradiction in this project as it has limited the scope of the improvements in measurement to contribution-based promises to avoid delaying the project.

8.9 The Board regards its proposed accounting for contribution-based promises as an improvement over IAS 19 and thinks it should not require entities applying improved accounting to revert to an inferior method of accounting after the accumulation phase. Nor does it intend to change the accounting for defined benefit plans in this project. Therefore, the Board's preliminary view is that there should be consistency of accounting for an obligation throughout its life. Accordingly, a contribution-based promise after the accumulation phase is measured at fair value assuming the terms of the benefit promise do not change.

8.10 The Board noted that if market prices were not available for annuities, the measurement of a contribution-based promise during the payout phase would require that entities determine a risk margin that includes the effect of demographic risk, particularly longevity risk. The Board recognises that there may be practical difficulties in determining that margin. Accordingly, Question 10(b) in the Invitation to Comment seeks views on the practical difficulties that entities might encounter.

Benefits in the deferment phase

8.11 When benefits are deferred, the employee no longer earns service-related benefits, but has not yet started to receive benefits. Given the Board's proposals for the measurement of the liability in the payout phase, the Board could see no reason to use a different measurement method in the deferment phase. Accordingly, in the Board's preliminary view, benefits in the deferment phase should be measured according to the classification of the promise in the accumulation phase.

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Chapter 9 Disaggregation, presentation and disclosure of contribution-based promises

9.1 This chapter discusses disaggregation, presentation and disclosures of contribution-based promises. The Board's preliminary views are that entities should:

- disaggregate changes in the value of the liability for a contribution-based promise into a service cost and other value changes.
- present in profit or loss all changes in the value of the liability for a contribution-based promise and all changes in any plan assets.
- disclose information about the liabilities for contribution-based promises for which it retains some risk. It should also disclose information about any related plan assets.

Disaggregation of the components of a contribution-based promise

9.2 IAS 19 does not require disaggregation of the costs of defined contribution plans. The contribution payable for the period is equal to the cost of service in the period and there is no remeasurement in subsequent periods. The entity recognises in profit or loss the contribution payable for the period.

9.3 For defined benefit plans, IAS 19 requires disaggregation of the change in the defined benefit liability into service cost, interest cost and actuarial gains and losses.

9.4 Service cost is the increase in the present value of the benefit obligation resulting from employee service in the current period. Disaggregating service cost from other components of cost is useful to users because it provides information about recurring costs associated with employees. For a contribution-based promise, the service cost for the period is the amount initially recognised for the liability for the contribution-based promise for that period.

9.5 The Board considered whether entities should be required to disaggregate other changes in a contribution-based promise liability into interest cost and actuarial gains and losses, as IAS 19 requires for defined benefit promises.

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9.6 Interest cost represents the cost of financing the obligation in the period. Disclosure of an interest cost is required for some other liabilities, such as debt, other financial instruments, and liabilities in the scope of IAS 37. It reflects the passage of time and the fact that the benefits are one period closer to settlement. Entities could calculate interest cost for a contribution-based promise, using the discount rate implicit in the fair value of the liability at the beginning of the year. Some users of financial statements state that identification and disclosure of an interest cost, even if not directly observable, is useful for decision making.

9.7 However, many interrelated assumptions are used in determining the fair value of a liability, including market interest rates, cash receipts and payments, the passage of time and demographic assumptions. These interrelated assumptions mean that any disaggregation of interest cost and other fair value changes would not be possible to achieve objectively. This is particularly true of promises that include guarantees or options, as do many contribution-based promises.

9.8 In interviews relating to financial instruments some users indicated that they do not find decision-useful disaggregation of changes in the fair value of financial instruments within the scope of IAS 39. The Board noted that this information was specific to financial instruments and may not be applicable to post-employment benefit liabilities. However, the Board thinks that, on balance, disaggregation of changes in the value of a contribution-based benefit liability, beyond identifying service cost from other fair value changes, would add complexity that outweighs the benefit of the additional information. Accordingly, in the Board's preliminary view, the change in value of a contribution-based liability should be disaggregated only into service cost and other fair value changes.

Presentation of the components of a contribution-based promise

9.9 Chapter 3 states that the Board has not formed a preliminary view on the best presentation approach for defined benefit promises, and describes three presentation approaches. In all three approaches, service cost, which represents the cost of employment in the current period, is presented in profit or loss.

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9.10 For the other fair value changes, the Board noted the following:

- under approach 1, all changes in the defined benefit obligation are presented in profit or loss. Under approaches 2 and 3, some components are presented in other comprehensive income. However, approaches 2 and 3 would require more disaggregation of the changes in the contribution-based liability than proposed above.
- changes in financial liabilities measured at fair value in accordance with IAS 39 are presented in profit or loss.

9.11 Accordingly, in the Board's preliminary view, entities should present in profit or loss service cost and other fair value changes arising from a contribution-based promise. For consistency, entities should also present in profit or loss all changes in any plan assets.

9.12 The Board will review this preliminary view in the light of any redeliberations on its preliminary view about disaggregation of changes in the value of contribution-based promises and the presentation approaches for defined benefit promises in Chapter 3.

Disclosure

9.13 The Board intends to review the disclosure requirements for all post-employment benefit promises comprehensively when it develops an exposure draft. For contribution-based promises, the Board's preliminary view is that entities should disclose the liabilities for contribution-based promises for which they retain some risk. Entities should also disclose information about any plan assets related to those liabilities.

Implications

Plans that IAS 19 classifies as defined contribution plans

9.14 The definition of contribution-based means that plans that are classified as defined contribution plans in IAS 19 would be reclassified as contribution-based. However, if the contributions are paid to the plan by the end of the period to which they relate, the only component of a defined contribution plan would be service cost. There would be no other fair value changes. Because contributions to a defined contribution plan are required by IAS 19 to be recognised in profit or loss, the presentation

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proposals in this chapter do not change the presentation requirements for many defined contribution plans.

9.15 Promises that IAS 19 classifies as defined contribution plans do not expose the entity to risk, once the required contributions have been paid, and thus would not result in additional disclosures beyond those in IAS 19.

Differences between defined benefit and contribution-based promises

9.16 This paper sets out different accounting models for defined benefit and contribution-based promises. The differences in disaggregation and presentation for defined benefit and contribution-based promises are summarised in the following table.

	Contribution-based promises	**Defined benefit promises**
Changes in value of plan assets and benefit liability disaggregated into:	• Service cost • Other changes in the fair value of the benefit liability, assuming the terms of the benefit promise do not change • Changes in value of plan assets	• Service cost • Interest cost • Actuarial gains and losses (including changes in value of plan assets)
Changes presented in profit or loss	All changes in value of plan assets and benefit liability	Approach 1: All changes Approach 2: Service cost and some actuarial gains or losses Approach 3: Service cost, interest cost, interest income and some actuarial gains or losses
Changes presented in other comprehensive income	None	Approach 1: None Approach 2: Interest cost and some actuarial gains or losses (including changes in value of plan assets) Approach 3: Some actuarial gains or losses (including changes in value of plan assets)

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9.17 Some think that the Board's proposals for contribution-based promises would result in different accounting for promises that are similar economically. Accordingly, some think that there should be as much consistency as possible between the presentation of contribution-based and defined benefit promises to minimise the effects of the Board's proposals for contribution-based promises. Accordingly, the Invitation to Comment asks whether the disaggregation and presentation of changes in the liability for contribution-based promises should mirror the requirements for defined benefit promises.

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Chapter 10 Benefit promises with a 'higher of' option

10.1 This chapter sets out the Board's proposals for benefit promises with a 'higher of' option. The Board's preliminary views are:

- When a post-employment benefit promise is the higher of a defined benefit promise or a contribution-based promise, entities should recognise and account for the 'host' defined benefit promise in the same way as a defined benefit promise and recognise the 'higher of' option separately.
- Entities should measure the 'higher of' option that is recognised separately from a host defined benefit promise at fair value assuming the terms of the benefit promise do not change.
- Entities should disaggregate a 'higher of' option that is recognised separately from a host defined benefit promise into a service cost and other changes in value, with both components presented in profit or loss.

Separate recognition of the 'higher of' option

10.2 In some cases, a post-employment benefit promise may be the higher of two promises. Such promises include the following:

(a) the higher of two defined benefit promises. Because the scope of this project is limited to addressing plans that contain a promised return on contributions, such promises are not within the scope of this project. The Board observed that the issues discussed below, in particular in paragraph 10.4, also apply to promises of the higher of two defined benefit promises, but decided not to address those issues in this project. Entities would continue to account for these promises as defined benefit.

(b) the higher of two contribution-based promises. Such promises can be expressed as a single contribution-based promise, for example, as the higher of a return linked to an equity index and a guaranteed minimum return. These promises are a contribution-based promise.

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(c) the higher of a defined benefit promise or a contribution-based promise, for example:

The employer promises a benefit equal to the higher of (a) and (b): (a) a lump sum benefit paid into a fund equal to 5 per cent of the employee's current salary for each year of service. The benefit promised at retirement is a lump sum equal to the contributions plus interest compounded at the rate of each year's return on a specified equity index. (b) a lump sum benefit equal to 5 per cent of final salary for each year of service.

10.3 The Board concluded that it is not necessary to develop guidance for the identification and measurement of the higher of two benefit promises, other than those in paragraph 10.2(c). The Board considered whether the promises in that paragraph should be:

(a) defined benefit promises;

(b) treated as a category other than contribution-based or defined benefit;

(c) contribution-based promises; or

(d) separated into a host promise and a 'higher of' option.

10.4 The Board noted that the promises in paragraph 10.2(c) are, under the proposed definitions, defined benefit promises. They are not contribution-based because they cannot be expressed as the accumulation of known contributions for periods of service and a return on those contributions. Thus, they would be measured using the projected unit credit method in IAS 19. However, the Board did not find this result satisfactory. The projected unit credit method uses point estimates to calculate the expected value of the liability, and thus ignores the value of the option to obtain the higher benefit. Embedded guarantees and options have a value whose recognition and measurement provides useful information. Ignoring the value of any option underestimates the liability. Accordingly, the Board decided that it should treat such promises differently from other defined benefit promises.

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10.5 In the Board's preliminary view, these promises should not be accounted for as a third category of benefit promises because it is unclear what measurement attribute could be applied to them in this project. Applying a new measurement attribute to these promises would be difficult pending a comprehensive review of the accounting for defined benefit promises.

10.6 The Board decided not to change the definition of contribution-based to include these promises because adding a contribution-based option with little value to a defined benefit promise would change its classification and result in different accounting. This would permit entities to structure promises to choose defined benefit or contribution-based accounting for economically similar promises. For example, if these promises are classified as contribution-based, a typical final salary plan that included a minor guarantee would be classified as contribution-based, rather than defined benefit. This would cause different accounting that would not be justified by an economic difference in the benefit promises.

10.7 Accordingly, the Board's preliminary view is that entities should separate these promises into a host promise and a 'higher of' option.

10.8 The Board decided that the host promise should be the defined benefit promise. As a result, when the value of an option to obtain a higher contribution-based promise is small, the promise would be measured at an amount similar to a defined benefit promise. Similarly, when the value of an option to obtain a higher contribution-based promise is large, the promise would reflect the larger amount of the liability. The advantage of this approach is that promises that are substantially defined benefit promises with an immaterial contribution-based option would continue to be accounted for using the projected unit credit method in IAS 19.

10.9 The Board decided that entities should:

(a) recognise and account for the host defined benefit promise in the same way as a defined benefit promise; and

(b) recognise the 'higher of' option separately.

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Measurement of the 'higher of' option that is recognised separately from a defined benefit host promise

10.10 The Board considered whether the entities should measure a 'higher of' option at its intrinsic value. The intrinsic value of the option is equal to the difference at the end of the reporting period between the liability for the defined benefit promise and the liability for the contribution-based promise. However, measuring the option at its intrinsic value would:

- ignore the value of any option that is out of the money at the reporting date.
- require comparison of two numbers that reflect different measurement approaches (projected unit credit for defined benefit promises and fair value assuming the terms of the benefit promise do not change for contribution-based promises).

10.11 The Board does not think that an intrinsic value measure for a 'higher of' option provides information about out of the money options or guarantees.

10.12 The 'higher of' option is similar to an embedded option written by the employer. IAS 39 requires entities to measure embedded derivatives, including options, at fair value. Accordingly, the Board considered whether the 'higher of' option should be measured at fair value. The Board noted that measuring the option at fair value would:

- incorporate both the intrinsic value and the time value of the option, thus better representing the obligation.
- not require the employer to determine the value of both the defined benefit promise and the contribution-based promise because the value of the option could be determined directly.
- result in promises in which the 'higher of' option is insignificant being measured at an amount similar to the host defined benefit promise, and promises in which the 'higher of' option has a large value reflecting the larger liability.
- be consistent with the treatment of financial options in IAS 39.

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10.13 However, as discussed in Chapter 7, the Board thinks that a more appropriate measurement attribute for post-employment benefit promises is *fair value assuming the terms of the benefit promise do not change*. Therefore, the Board's preliminary view is that entities should measure the 'higher of' option at fair value, assuming the terms of the benefit promise do not change, consistently with the measurement proposed for contribution-based promises.

Disaggregation and presentation of the 'higher of' option that is recognised separately from a defined benefit host promise

10.14 For consistency with the proposals in Chapter 9, the Board's preliminary view is that entities should disaggregate a 'higher of' option that is recognised separately from a host defined benefit promise into a service cost and other changes in value, with both components presented in profit or loss.

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Appendix A
Classification of benefit promises

Promise	**Description**	**Classification and reference in Chapter 5**
Promise 1	The employer promises a benefit equal to: • for the first 15 years of service, a lump sum benefit accumulated as follows: the entity pays contributions of 8 per cent of salary for each year of service and the return on contributions is equal to the return on an equity index. • for the next 15 years' service, a lump sum equal to 3 per cent of final salary for each year of service.	Contribution-based for first 15 years, defined benefit for next 15 years *[paragraphs 5.6–5.7]*
Promise 2	The employer promises to make contributions into a fund of 5 per cent of the employee's salary during the current reporting period for each year of service. The benefit promise at retirement is a lump sum equal to the contributions increased with the compound return on a specified equity index.	Contribution-based *[paragraph 5.9]*
Promise 3	The employer promises to make contributions into a fund of 5 per cent of the employee's current salary for each year of service. The benefit promise at retirement is a lump sum equal to the contributions paid plus the actual investment returns on those contributions.	Contribution-based *[paragraphs 5.17–5.23]*
Promise 4	The employer promises to make notional contributions of 5 per cent of the employee's current salary for each year of service. The benefit promise at retirement is a lump sum equal to the notional contributions increased by interest compounded at the rate of each year's return on a specified equity index.	Contribution-based *[paragraph 5.26]*

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Promise	Description	Classification and reference in Chapter 5
Promise 5	The employer promises to make notional contributions of 5 per cent of the employee's current salary for each year of service. The benefit promise at retirement is a lump sum equal to the contributions plus a fixed return on the contributions of 3 per cent per year.	Contribution-based *[paragraphs 5.30–5.32]*
Promise 6	The employer promises to make notional contributions of 5 per cent of the employee's current salary for each year of service. The benefit promise at retirement is a lump sum equal to the contributions plus a fixed return on the contributions of 0 per cent per year.	Contribution-based *[paragraphs 5.33–5.37]*
Promise 7	The benefit is a lump sum at retirement equal to 5 per cent of the career average of the employee's salary for each year of service.	Contribution-based *[paragraphs 5.33–5.37]*
Promise 8	The benefit is a lump sum at retirement equal to 5 per cent of the employee's final salary at retirement for each year of service.	Defined benefit *[paragraph 5.38]*
Promise 9	The benefit is a lump sum at retirement equal to 5 per cent of the average of the employee's final three years' salary before retirement, for each year of service.	Defined benefit *[paragraphs 5.38–5.48]*
Promise 10	The employer promises to make contributions into a fund for each year of service. The contribution in each period of service is 5 per cent of the average of the employee's salary in the most recent two years of service. The benefit promise at retirement is a lump sum equal to the contributions paid.	Contribution-based *[paragraphs 5.44–5.46]*
Promise 11	The benefit is a lump sum benefit at retirement equal to the number of years' service multiplied by 5 per cent of the average of the employee's salary in the most recent (ie final) two years of service.	Defined benefit *[paragraphs 5.44–5.46]*

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Promise	Description	Classification and reference in Chapter 5
Promise 12	The employer promises to contribute into a separate fund 5 per cent of the employee's salary for each year of service. The lump sum at retirement, which is equal to the accumulated contributions plus the investment returns they earn, is converted into a pension at a fixed annuity rate (ie the cost of buying a pension is fixed when the promise is made, rather than being determined by the market rates at retirement date). That pension amount is payable in monthly instalments for the life of the retired employee.	Contribution-based *[paragraphs 5.53–5.56]*
Promise 13	The employer promises to contribute CU100,000 into a separate fund on the first day of service. The lump sum at retirement is the contribution of CU100,000, plus a fixed return of 0 per cent. The lump sum is converted into a pension at a fixed annuity rate (ie the cost of buying a pension is fixed when the promise is made, rather than being determined by the market rates at retirement date). This generates a benefit of CU1,000 per year for the life of the retired employee.	Contribution-based *[paragraphs 5.53–5.56]*
Promise 14	The employer promises a benefit of CU1,000 per year for each year after the employee retires until his death, regardless of the service period of the employee.	Contribution-based *[paragraphs 5.57–5.59]*

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Appendix B
Comparison of a current salary promise with a fixed return of 0 per cent and a career average salary promise

This appendix illustrates that a current salary promise with a promised fixed return of 0 per cent on contributions is economically identical to a career average salary promise. When the averaging period for salary increases is the same as the qualifying service period for the current salary promise, the promises provide exactly the same benefit, whenever an employee leaves service. This is because the sum of the benefit promised in each year in a current salary promise is equal to the average benefit multiplied by the number of years in the career average promise.

Consider the following promises:

> **Promise 6** The employer promises to make notional contributions of 5 per cent of the employee's current salary for each year of service. The benefit promise at retirement is a lump sum equal to the contributions plus a fixed return on the contributions of 0 per cent per year.
>
> **Promise 7** The benefit is a lump sum at retirement equal to 5 per cent of the career average of the employee's salary for each year of service.

Let t be the number of years service and *Sal(t)* be the salary in year t

For Promise 6, the benefit is the accumulation of 5 per cent of salary in current and prior years, ie:

$$[5\% \times Sal(1)] + [5\% \times Sal(2)] + \ldots + [5\% \times Sal(\mathrm{t}(1)] + [5\% \times Sal(\mathrm{t})]$$

$$= 5\% \times [Sal(1) + Sal(2) + \ldots + Sal(\mathrm{t}(1) + Sal(\mathrm{t})]$$

$$= 5\% \times t \times [Sal(1) + Sal(2) + \ldots + Sal(\mathrm{t}(1) + Sal(\mathrm{t})]/t$$

$$= 5\% \times t \times [\text{career average salary}]$$

This is the same as the benefit in Promise 7.

Thus, the only difference between the two promises is the way in which the benefit formula is expressed.

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Appendix C
Comparison of the Board's preliminary views for contribution-based promises with the existing IAS 19 requirements

IAS 19 classifies some contribution-based promises as defined benefit plans. The following table gives a high level summary of the differences between the Board's preliminary view on contribution-based promises and the requirements of IAS 19.

	Requirements of IAS 19	**Proposals in this paper**
1	Applies to post-employment benefit *plans*	Applies to post-employment benefit promises
2	Definition depends on risk to the employer	Definition depends on contributions being known, except for vesting and demographic risks, during the accumulation phase and on any promised return being linked to an asset, group of assets or an index
3	Defined benefit plans are all those that do not meet the definition of defined contribution.	Defined benefit plans are all those that do not meet the definition of contribution-based
4	Defined contribution plans require the entity to pay fixed contributions into a separate entity, with no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in current and prior periods.	A *contribution-based promise* is a post-employment benefit promise in which, during the accumulation phase, the benefit can be expressed as (a) the accumulation of actual or notional contributions that, for any reporting period, would be known at the end of that period, except for the effect of any vesting or demographic risk; and (b) any promised return on the actual or notional contributions is linked to the return from an asset, group of assets or an index. A contribution-based promise need not include a promised return. Contribution-based promises include those that IAS 19 classifies as defined contribution.
5	Benefit promises with 'higher of' option classified as defined benefit	Benefit promises with 'higher of' option separated into host defined benefit promise and a separate 'higher of' option

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	Requirements of IAS 19	**Proposals in this paper**
	Measurement of contribution-based promises	
6	Projected unit credit method	Fair value assuming the terms of the benefit promise do not change
	Measurement of promises with a 'higher of' option	
7	Projected unit credit method	A promise of the higher of two defined benefit promises is measured using projected unit credit method. If promise of the higher of two contribution-based promises is measured at fair value assuming the terms of the benefit promise do not change. A promise of the higher of a defined benefit and a contribution-based promise is measured as follows: (a) the host defined benefit promise is measured using the projected unit credit method and (a) the 'higher of' option is measured at fair value assuming the terms of the benefit promise do not change.
	Measurement of obligation to pay benefits after accumulation phase	
8	Projected unit credit method	Benefits accumulated through defined benefit promise are measured using projected unit credit method. Benefits accumulated through contribution-based promises are measured at fair value assuming the terms of the benefit promise do not change.
	Disaggregation of contribution-based promises	
9	Change in the defined benefit liability disaggregated into a service cost, interest cost and actuarial gains and losses.	Change in contribution-based promise liability disaggregated into service cost and other value changes only.
	Presentation	
10	As for defined benefit plans. The presentation of defined benefit promises is subject to the proposals in Chapters 1–3.	All changes presented in profit or loss.

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