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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IFRIC meeting: **May 2007, London**

Project: **IAS 19 *Employee Benefits*: The asset ceiling and minimum funding requirements (Agenda Paper 5)**

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1. At the last meeting, the IFRIC considered issues arising from the comments on D19 *IAS 19 – The Asset Ceiling: Availability of Economic Benefits and Minimum Funding Requirements*. The IFRIC decided to proceed to a final Interpretation, with a number of amendments to D19 in the light of comments received.

2. Drafts of the Interpretation are attached as Agenda Paper 5(i) (clean version) and Agenda Paper 5(ii) (changes from D19 marked up) [Agenda Papers 5(i) and 5(ii) not reproduced in observer notes]. The staff wishes to raise the following issues with the IFRIC:

    a. additional guidance and examples on what is a minimum funding requirement

    b. the requirements relating to an entity's rights to a refund

c. the assumptions underlying the future service cost used to determine the reduction in future contributions

d. consistency between the assumptions underlying the economic benefit available as a refund and the economic benefit available as a reduction in future contributions.

Questions for the IFRIC are set out in boxes in the relevant sections of the paper.

3. The objectives of the discussion at this meeting are to:

   a. resolve outstanding issues, as set out in this paper;

   b. approve the drafting of changes in the Interpretation decided at the last meeting;

   c. consider the need for re-exposure;

   d. if not re-exposing, confirm the effective date; and

   e. approve the Interpretation.

Additional guidance and examples on what is a minimum funding requirement

4. At the last IFRIC meeting, the IFRIC decided that the Interpretation would address all MFR obligations but would give no further guidance in respect of whether an agreement with the Trustees or a similar non-statutory agreement would create such an obligation. The Interpretation would, however, make clear that MFR obligations do not include promises such as an undertaking in an employment contract to contribute a specified percentage of the employee's remuneration for each year of service.

5. The staff has added requirements to the scope of the Interpretation (paragraph 5) that state that:

a. the Interpretation only applies to defined benefit plans. Therefore, any requirements to contribute to a defined contribution plan are not minimum funding requirements for the purpose of the Interpretation.

b. minimum funding requirements are any requirements that create a legal or constructive obligation for the entity to make contributions to *fund* a post-employment or other long-term defined benefit plan (emphasis added). Therefore a benefit promise defined in terms of notional contributions is not a minimum funding requirement for the purpose of the Interpretation.

6. The staff has added examples (IE1-IE3) to illustrate those points and two further examples (IE4 and IE 5) to illustrate agreements with Trustees that are legally enforceable. Example IE 2 is taken from Australia and examples IE4 and IE5 from the UK. The comment letters asking for clarification on the definition of an MFR came from these jurisdictions.

Does the IFRIC agree with the additional guidance and examples?

Requirements relating to an entity's rights to a refund

7. At the last IFRIC meeting, the IFRIC decided that an entity should recognize a potential refund as an asset only if the entity has an unconditional right to that refund. The staff has amended the Interpretation accordingly (paragraphs 10 and 11). The staff has also added guidance that:

a. the entity's intentions with respect to the use of the surplus do not affect the existence of the asset; and

b. if the entity's right to a refund depends on the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity, the refund is contingent (conditional) and the entity shall not recognise it.

8. Point (a) addresses respondent concerns that an entity might intend to use the surplus for enhanced benefits rather than take a refund. The staff wishes to

emphasise that such intentions do not affect the existence of the asset at the balance sheet date.

> Does the IFRIC agree that an entity's intended use of a surplus does not affect the existence of an asset at the balance sheet date?

9. Point (b) is intended to clarify the treatment of refunds that are dependant on the actions of others, for example trustees or court cases. Under IAS 19 an asset exists in respect of a surplus if, inter alia, refunds are available to the entity (paragraph 59 of IAS 19). The IFRIC's decision limits the interpretation of "refunds available to the entity" to refunds to which an entity has a right. The staff understands that the IFRIC intended refunds that are dependant on the actions of others, for example trustees or court cases, would not be recognised.

10. The staff agrees that conclusion is consistent with the treatment of contingent assets under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Under IAS 37, contingent assets are possible assets that arise from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain events not wholly within the control of the entity. Contingent assets are not recognized.

11. The Board has issued proposals amending the analysis and treatment of contingent assets. The staff does not think that the IFRIC should base its current decisions about refunds on those proposals. But the staff would like to link the analysis of the right to a refund directly to the treatment of contingent assets so that, if the Board's proposals in the ED of amendments to IAS 37 proceed, the treatment of the asset relating to a refund is also amended. If the refund is described as a contingent asset in the Interpretation, the amendments to IAS 37 will include a change to the Interpretation as a consequential amendment.

12. The Basis for Conclusions on the ED of amendments to IAS 37 analyses contingent assets in terms of conditional and unconditional rights. An asset exists in respect of the unconditional rights but does not exist in respect of the

conditional rights. The following extract analyses two examples of contingent assets:

> The Board considered some other examples of contingent assets. Two examples are an entity that has applied for an operating licence and an entity that is negotiating a significant contract with a customer with whom it has had no prior contractual relationship. In these two examples, the Board concluded that the operating licence and the contract are conditional rights. This is because the rights are conditional (or contingent) on a future event (ie decision of the awarding authority or the customer signing the contract). However, in both cases the entity has an asset. In the case of the licence application, the asset arises from the entity's unconditional right to participate in the process of bidding for the licence. In the case of a pending customer contract, the asset arises from the entity's unconditional right to the economic value of the developing contractual relationship.

13. The staff would argue that when an entity's right to a refund from a defined benefit plan is dependant on the actions of others, the right to the refund is conditional. However, the entity still has an asset, which is the unconditional right to ask for a refund as the sponsor of the plan. The economic value of that asset will depend on the likelihood of the refund being granted. Of course, if the trust deeds for the plan or law in the jurisdiction prohibit refunds, then the sponsor has no right to ask for a refund and there is no unconditional asset.

Does the IFRIC agree that the analysis of a right to a refund should be linked to the treatment of contingent assets under IAS 37?

The assumptions underlying the future service cost used to determine the reduction in future contributions

14. At the last meeting, the IFRIC decided that in measuring the asset available as a reduction in future contributions, projections of future service cost should be based on a stable membership with retirements, deaths and leavers replaced by

new entrants and with other assumptions consistent with those underlying the calculation of the defined benefit obligation under IAS 19.

15. The following table sets out the facts and assumptions needed to measure the defined benefit obligation under IAS 19 and the assumptions needed to measure the asset available as a reduction in future contributions. These later assumptions should be specified in the Interpretation.

	Defined benefit obligation	**Reduction in future contributions**
Benefits attributed to past service	Known	Not needed
Future workforce	Not needed	Assumption needed
Future benefits	Not needed, except as discussed in paragraph 16 below	Assumption needed
Future salary increases	Best estimate	Assumption needed
Demographic assumptions about existing workforce	Best estimate	Assumption needed
Demographic assumptions about future workforce	Not needed	Assumption needed
Discount rate	High quality corporate bond rate	High quality corporate bond rate

16. Usually, the defined benefit obligation depends only on benefits earned to date. The only time that future benefits affect the calculation of the defined benefit obligation is when the benefit formula attributes materially higher levels of

benefit to later years of service. In that case, IAS 19 requires the total expected benefit to be recognized on a straight-line basis over the expected service period. A change in future benefits affects the total expected benefit and, so, the amount that would be recognized on a straight-line basis.

17. That situation, and the effect of changes in expected future salaries, are the only causes of a gain or loss arising from a remeasurement on curtailment[1]. IAS 19 does not permit curtailments (ie reductions in future benefits) to be anticipated in the measurement of the defined benefit obligation.

18. So, as can be seen from the table above, in the calculation of the defined benefit obligation IAS 19 generally requires a best estimate of factors that are not fixed at the balance sheet date. The only exception is for future changes in benefits, as noted in paragraph 16 above.

19. When measuring the asset available as a reduction in future contributions, we need to make assumptions about future events. Some of these assumptions are also needed for the calculation of the defined benefit obligation, such as future salary increases, and some are not.

20. The staff has previously argued that the assumptions about the future workforce should be based on management forecasts and budgets, ie should be the entity's best estimate. The staff also notes that the IFRIC decided that the period over which the reduction in contributions should be calculated should be the shorter of the expected life of the plan and the expected life of the entity. That implies that, in the extreme case of an entity ceasing to exist, a reduction in the workforce (to nil) would be assumed. Further, the staff argues that if it is known that the future workforce will decline (for example if the plan is closed to new members), assuming a stable workforce could significantly overstate that asset available as a reduction in future contributions.

[1] Other gains and losses may be *recognized* on a curtailment because of the requirement to recognize previously unrecognized amounts. But they do not arise from a remeasurement on curtailment.

21. At the last IFRIC meeting, it was noted that the assumptions underlying the calculation of the reduction in future contributions should all be internally consistent. The staff agrees. The staff analyses two choices for the assumptions as follows:

    a. require all the assumptions underlying the reduction in future contributions to be best estimates. This would be consistent with the calculation of the defined benefit obligation, except as set out in paragraph 16 above. It would also be consistent with the period over which the reduction can be calculated being the shorter of the entity's life and the plan life and the calculation of recoverable amount in IAS 36. Further, in the staff's view, it would give the best economic measure of the entity's asset.

    b. require all the assumptions underlying the reduction in future contributions to be based on the situation at the balance sheet date, with the exception of assumptions about future salaries and demographic assumptions about the current workforce. The future workforce would be assumed to be the same size and have the same demographic profile as the existing workforce. This would be consistent with the calculation of the defined benefit obligation, but includes an internal inconsistency in the treatment of future changes in benefits (not anticipated) and future salaries (anticipated).[2] It also conflicts with the period of the reduction being the entity's life if that is shorter than the expected plan life. Further, the staff thinks it would give a misleading view of the economic benefit available to the entity when the entity forecasts either substantial reductions or increases in the workforce.

22. The staff recommends approach (a).

Does the IFRIC agree with the staff recommendation?

[2] The staff acknowledges that this internal inconsistency is currently present in the measurement of the defined benefit obligation under IAS 19, but only arises in the circumstances set out in paragraph 16.

Consistency between the assumptions underlying the economic benefit available as a refund and the economic benefit available as a reduction in future contributions

23. A Board member noted that the assumptions underlying the economic benefit available as a refund and the economic benefits available as a reduction in future contributions should be consistent. An entity cannot recognize an asset based on a refund that is available if the plan is gradually wound up *and* an asset based on reductions in future contributions that would be available if the plan continues with a stable workforce.

24. The staff agrees that an asset cannot be recognized based on mutually exclusive economic benefits available as a refund and as a reduction in future contributions. The staff argues that the asset should be based on the best use of the surplus by the entity, regardless of the entity's intentions. This may be based on a refund or a reduction in future contributions or a combination of both. If it is based on a combination of both, then the assumptions underlying the two aspects should be consistent. But an entity will need to consider a combination of the two only if both a refund and a reduction in contributions are available to some extent *and* neither is sufficient on its own to support an asset equal to the surplus.

25. Consider an entity that has a surplus in a defined benefit plan of 100. The entity has a right to a refund of 50% of the surplus when all the plan liabilities are settled and the maximum reduction in future contributions is 70 assuming a continuing stable workforce (which is the entity's best estimate). Now it might seem inconsistent to recognize an asset of 100[3] because the entity cannot both settle all the plan liabilities and keep the plan going with a stable workforce. But the entity may be able to get reductions in future contributions of almost 70 by running the plan for 60 years and then get the refund of 50%. Because the surplus is measured in present value terms, the value today of the refund in 60 years' time is 50. So the entity can recognize the total surplus as an asset.

[3] The asset of 100 could be based on 50 of a refund and 50 of reductions in future contributions or 70 of reductions in future contributions and 30 of refund.

26. So, in practice, the staff thinks a conflict will not arise often. Nonetheless for clarity and completeness, the staff recommends adding the following paragraph to the Interpretation.

> An entity shall determine the maximum economic benefit that is available from refunds, reductions in future contributions or a combination of both. An entity shall not recognise economic benefits from a combination of refunds and reductions in future contributions that are mutually exclusive.

Does the IFRIC agree with the staff recommendation?

Title and scope of the Interpretation

27. At the last IFRIC meeting, the IFRIC asked the staff to develop a title for the Interpretation that clearly identifies the issues covered by the Interpretation. The Interpretation gives guidance on:

    a. general aspects of when refunds or reductions in future contributions should be regarded as available

    b. how a minimum funding requirement might affect the availability of reductions in future contributions and

    c. how the interaction between the limit on measurement of a defined benefit asset and a minimum funding requirement might give rise to a liability.

28. The staff recommends the title should be *IAS 19—The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction.*

Does the IFRIC agree with the staff recommendation?

Minor points raised by respondents

29. Minor points raised by respondents and the staff response are noted in the appendix to this paper. [Appendix not reproduced in observer notes.] None of these points will be discussed at this meeting, unless an IFRIC member requests a discussion.

Are there any other matters that you think need to be discussed in the meeting?

Re-exposure

30. The *Due Process Handbook for the IFRIC* states that:

> 40 If the proposed Interpretation is changed significantly, the IFRIC will consider whether it should be re-exposed. Re-exposure is not required automatically and will depend on the significance of the changes contemplated, whether they were raised in the Basis for Conclusions on the draft Interpretation or in questions posed by the IFRIC, their significance for practice and what might be learned by the IFRIC from re-exposure.

31. The Interpretation has been altered in the following significant respects since it was exposed for comment as D19:

    a. The staff proposals on linking the treatment of potential refunds with that of contingent assets under IAS 37 (paragraphs 7-13 above) clarify a matter on which the draft Interpretation was silent. The staff does not think this change needs re-exposure.

    b. The staff recommendation on the assumptions underlying the measurement of a reduction in future contributions (paragraphs 14-22 above) would be a clarification of and a change from the proposals in the draft Interpretation. This issue was discussed in the Basis for Conclusions on the draft Interpretation. The staff does not think this change needs re-exposure.

    c. The staff recommendation on the consistency of assumptions underlying a refund and a reduction in future contributions (paragraphs 23-26 above) would be a clarification of the proposals in the draft Interpretation. The staff does not think this change needs re-exposure.

d. The draft Interpretation proposed retrospective application. The IFRIC decided to change this to application from the beginning of the first period presented in the first financial statements to which the Interpretation applies. This change was made in response to concerns that retrospective application would be unduly complex and costly. The staff does not think this change needs re-exposure.

Does the IFRIC agree that the Interpretation does not need to be re-exposed?

Effective date

32. If the Interpretation is approved by the IFRIC at this meeting, it is likely that it will be issued in late June or early July.

33. The staff therefore recommends that the Interpretation should be effective for reporting periods beginning on or after 1 January 2008. This would give a lead time of approximately 6 months.

Does the IFRIC agree?

Vote to confirm consensus

34. If no substantial issues arise from the matters discussed above, the IFRIC will be asked to vote to confirm the consensus at this meeting. If no more than three members vote against the proposal, the Interpretation will be put the IASB for ratification at its June meeting.