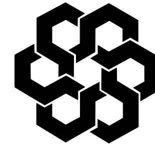

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International Accounting Standards Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **November 2008, London**

Project: **IFRIC 14 *IAS 19 – The Limit on a Defined benefit Asset, Minimum Funding Requirements and their Interaction***
Stable workforce assumption (Agenda Paper 5B)

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1. In September 2008 the IFRIC published a tentative agenda decision not to add an item to its agenda relating to the stable workforce assumption required by IFRIC 14 when an entity determines the economic benefit available as a reduction in future contributions.

2. Three comment letters were received.

3. One comment letter agrees with the IFRIC decision not to add the issue to its agenda, subject to a minor drafting change that the staff has reflected in the draft wording below.

4. One comment letter agrees with the IFRIC decision not to add to its agenda the issue identified in the tentative agenda decision, but notes that there are other issues underlying the problem noted in the submission to the IFRIC that should be considered before the tentative agenda decision is finalised.

5. The other comment letter disagrees with the tentative agenda decision and asks the IFRIC to reconsider its decision.

Staff Analysis

6. At the September meeting, the staff indicated that although it thought the requirements of IFRIC 14 regarding the assumption of a stable workforce were clear, it also thought that there were other aspects of IFRIC 14 that were causing the problem identified in the submission.

7. That problem occurs when an entity voluntarily prepays minimum funding requirement contributions to a defined benefit plan. The prepayment means that the entity will pay lower contributions in the future. But under the requirements of IFRIC 14, the surplus in the plan created by the prepayment may not be regarded as available as an economic benefit. The prepayment is therefore recognised as an expense.

8. The staff thinks that the problem is caused by two aspects of IFRIC 14. Paragraph 16 of IFRIC 14 states:

> If there is no minimum funding requirement, an entity shall determine the economic benefit available as a reduction in future contributions as the lower of:
>
> a) the surplus in the plan and
>
> b) the present value of the future service cost to the entity, ie excluding any part of the future cost that will be borne by employees, for each year over the shorter of the expected life of the plan and the expected life of the entity.

9. Paragraph 20 of IFRIC 14 states:

> If there is a minimum funding requirement for contributions relating to the future accrual of benefits, an entity shall determine the economic benefit available as a reduction in future contributions as the present value of:
>
> a) the estimated future service cost in each year in accordance with paragraphs 16 and 17 less
>
> b) the estimated minimum funding contributions required in respect of the future accrual of benefits in that year.

10. Paragraph 22 of IFRIC 14 states:

If the future minimum funding contribution required in respect of the future accrual of benefits exceeds the future IAS 19 service cost in any given year, the present value of that excess reduces the amount of the asset available as a reduction in future contributions at the end of the reporting period.

11. The two issues identified by the staff are also the issues raised by the second comment letter. They are:

    a) the wording of paragraph 22 of IFRIC 14 which requires an entity to include in the assessment of whether there is an asset at the reporting date particular expected cash outflows. Their inclusion implies there is a liability at the reporting date when there is not.

    b) the requirement in IFRIC 14 to use the future service cost as a proxy for the cash outflows that can be avoided by the entity even if the future service cost is determined not by the benefit formula but on a straight-line basis in accordance with IAS 19.67. As explained below, the staff now thinks this requirement is not a problem.

    These issues are illustrated in the following examples. For simplicity the examples assume a discount rate and expected return on assets of 0%. The staff knows that these are not realistic assumptions, but they enable the points at issue to be illustrated more clearly.

Issue a

12. An entity expects a service charge of 10 for a 10-year period[1] and is subject to a minimum funding requirement charge of 15 each year. No refunds are available from the plan.

Year	1	2	3	4	**5**	6	7	8	9	10
Service charge	10	10	10	10	**10**	10	10	10	10	10
Minimum funding	15	15	15	15	**15**	15	15	15	15	15

[1] In this example, for simplicity, the service cost derives directly from the benefit formula rather than from a straight-line recognition of back-end loaded benefits. The effect of the latter is discussed below.

requirement										

13. Consider year 5 and assume that everything has happened according to expectations, ie there are no actuarial gains and losses. The entity will have made contributions of 75 (=15*5) in accordance with the minimum funding requirement. However, the service charge over those 5 years will be only 50 (=5*10). Thus, there is a surplus of 25.

14. For the remaining 5 years, there will be a future service charge of 50 and future payments of 75 to satisfy the MFR. Thus, no surplus is recoverable. That is consistent with the intention behind IFRIC 14.

15. However, suppose the entity makes a prepayment of 30 at the beginning of year 5. The surplus at the end of year 5 is then 55 (=25+30). Intuitively, the prepayment of 30 should be wholly recoverable because it is available to reduce the required minimum funding contributions in years 6 and 7. The expected service cost and MFR contributions would be:

Year	6	7	8	9	10
Service charge	10	10	10	10	10
Minimum funding requirement	0	0	15	15	15

16. However, IFRIC 14 states that the recoverable surplus is the difference between the future service charge of 50 and future MFR payments of 45, ie only 5.

17. The staff thinks that the problem is that paragraph 22 of IFRIC 14 requires the excess of the MFR payment over the service cost in any year to reduce the amount of the asset available as a reduction in future contributions. But the expectation of paying that excess does not create a liability at the reporting date. For example, IFRIC 14 does not require recognition at year 0 of a liability of 50 for the total excess of the MFR payments over the service cost. It would be consistent with this view also not to anticipate the excess in determining whether the surplus at the reporting date is recoverable.

18. The staff has yet to work out the best way to resolve the issue. One way would be to change paragraph 22 of IFRIC 14 so that the excess of the MFR payments over the service cost in any future year does not affect the asset available as a reduction in future contributions. But that would still only give an asset in the above example of 20 ((10-0)+(10-0)+(10-10)+(10-10)+(10-10)), not 30. That approach takes the view that 20 is a prepayment of the future service cost of 10 in each of years 6 and 7, and 10 is a prepayment of the future irrecoverable amount of 5 in each of those years. This results in the latter amount being recognised as an expense when the prepayment is made. Alternatively, it could be argued that, until the entity actually reduces the contributions in years 6 and 7 to nil, all of the 30 could be regarded as a prepayment of the future service cost. The staff would need to think further on this.

Issue b

19. The second comment letter indicates that the effect of recognising the benefit on a straight-line basis rather than according to the benefit formula should be excluded when using future service costs as a proxy for future contributions in accordance with IFRIC 14.16(b) and IFRIC 14.20(a). The staff also originally though this was a problem, but now thinks it is not. This issue is illustrated below.

20. An entity promises a benefit that would give rise to the following service cost if IAS 19.67 did not apply and which the entity plans to fund in accordance with the benefit formula. The figures below are for an individual employee. The impact over a whole workforce is discussed later in the paper.

Year	1	2	3	**4**	5	6	7	8	9	10
Service cost according to the benefit formula, and contribution	10	20	30	**40**	50	60	70	80	90	100
Service cost recognised in	55	55	55	**55**	55	55	55	55	55	55

accordance with IAS 19.67[2]										

21. Because IAS 19 requires the service charge to be recognised on a straight-line basis, a deficit builds up over the first 5 years which reverses over the last 5 years. For example, if experience follows expectations, then in year 4:

Contribution paid (= 10+20+30+40)	120
Service charge (=55*4)	220
Deficit	(100)

22. In year 4, assume the entity makes a prepayment of 430. This prepayment will reduce the contributions required in the next 6 years. The surplus in the plan would be 330, being the prepayment of 430 less the deficit of 100. Under IFRIC 14 this would be regarded as recoverable through reductions in future contributions because the future service cost is also 330.

23. However, suppose the investment returns in the fund are better than expected and there is no deficit before the prepayment in year 4. The surplus in the plan is then equal to the prepayment of 430. IFRIC 14 states that the recoverable surplus is only 330, ie the future service cost to the entity. But it might be thought that the full 430 is recoverable by reductions in future contributions of 430.

24. However, in fact the surplus of 430 includes the excess investment return of 100. That excess return is not recoverable by the entity. Assume that over the remaining service life of the employee, experience accords with the assumptions. The entity will recognise service cost expense of 330, dr service cost expense, cr pension asset 330. If the surplus of 430 had been recognised as an asset, there would an asset of 100 remaining, which cannot be recovered as a refund.

25. The staff therefore thinks that no amendment to IFRIC 14 is needed in relation to the effect of recognising benefits on a straight-line basis.

Possible action

[2] The service cost in each year is calculated by attributing the benefit for the 10 years on a straight-line basis.

26. The staff concludes that issue (a) causes a problem when an entity voluntarily prepays contributions under a minimum funding requirement. The staff thinks that the clearest way of resolving the issue would be to amend the wording in IFRIC 14, rather than to issue further interpretations. The staff notes the following possible ways that this might be done:

    a) By work developed by the IFRIC leading to an individual ED approved by the Board

    b) By work developed by the IFRIC included as part of the Board's annual improvements project or

    c) As part of the Board project on amendments to IAS 19.

27. The staff thinks that the results given by IFRIC 14 in the circumstances in question are unintended and arguably not representationally faithful. The staff therefore recommends that the issue be dealt with by one of the above methods. The staff notes that (a) would be the fastest option, followed by (b). But the staff also notes that the Board project on IAS 19 will incorporate IFRIC 14 into the text of IAS 19. Dealing with this issue as part of that project would, therefore, probably be the most efficient method in terms of staff and Board resources, and would result in fewer documents issued for comment on IAS 19.

28. The staff notes that we could include in the IFRIC rejection wording an acknowledgement that there are issues to be resolved. The staff asks the IFRIC's views on whether doing so would be sufficient to allow preparers and auditors to manage the problem until it is resolved as part of the amendments to IAS 19, expected to be finalised in 2011. If so, the staff recommends that course of action.

29. The staff has set out proposed wording for the final agenda decision on that basis in Appendix A.

Question for the IFRIC

30. Does the IFRIC agree with the staff recommendations?

[Appendix A omitted from observer note]