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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: **September 2008, London**
Project: **IAS 19 and IFRIC 14 – Stable workforce assumption (Agenda Paper 6C)**

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1. The IFRIC has received a request to address an issue arising from IFRIC 14 *IAS 19-The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*. The full request is reproduced in Appendix A.

2. IAS 19 limits the asset that an entity can recognise for a surplus in a defined benefit pension plan to the economic benefit available to the entity from both refunds from the plan and reductions in future contributions to the plan. IFRIC 14 gives guidance on how to determine that amount. The issue raised in the request relates to the economic benefit available in the form of reductions in future contributions when there is a minimum funding requirement.

3. IFRIC 14 requires the economic benefit available as reductions in future contributions to be the present value of:

   a. the future service cost to the entity for each year less

   b. the estimated minimum funding contributions required in respect of the future accrual of benefits in that year.

4. In determining the future service cost, IFRIC 14 requires the entity to assume a stable workforce unless the entity is demonstrably committed to make a reduction in the number of employees covered by the plan. The request argues that this assumption may result in an inappropriate assessment of the economic benefits available to the entity as a reduction in future contributions. Under some circumstances, the economic benefit is understated. This affects not only the statement of financial position but also profit or loss. Contributions made to a plan that are regarded under IFRIC 14 as providing no economic benefits are recognised as an expense, not an asset. The request notes that by choosing the timing and the level of such contributions, an entity can affect its reported earnings.

5. The staff notes that this effect on profit or loss does not of itself indicate that there is a problem with IFRIC 14. It is a natural consequence of the asset ceiling in IAS 19. If an entity can prepay contributions that will be required by a minimum funding requirement and that result in no economic benefit to the entity, the timing of the contributions will determine the recognition of the expense.

6. So the issue is not the fact that the timing of voluntary contributions affects the timing of the recognition of an expense. And the staff can see no reason to treat the voluntary contributions as a separate pension asset to which the asset ceiling does not apply, as set out in the request in the illustration of the accounting treatment under common practice.

7. Rather the issue is more general: is the determination of the economic benefit available from reductions in future contributions as required by IFRIC 14 appropriate? In particular, is the assumption of a stable workforce appropriate?

8. The staff notes that this was an issue that was discussed at length by the IFRIC in developing IFRIC 14. The staff also notes that the wording of the consensus refers to 'a stable workforce' (paragraph 17) and the basis for conclusions explains that changes in the size of the workforce or in the benefits provided should not be anticipated. Decreases in the size of the workforce or the benefits should be included in the assumptions for the future service cost at the same time as they are treated as curtailments under IAS 19.

9. The request argues that the effect of an ageing workforce should be included in the determination of the service cost. The request assumes that this is not allowed given the requirement to assume a stable workforce. The staff notes that the basis for conclusions does not discuss the effect of an ageing workforce, and that it might be possible to take assume a workforce that is stable in size, but getting older on average. However, the staff acknowledges that this would require leavers to be replaced by joiners of at least the same age, which is perhaps unlikely. Further the request also notes that the service cost under IAS 19 would be recognised on a straight-line basis rather than according to the benefit formula, so it is not clear to the staff that an assumption of an ageing workforce would have the desired effect on the future service cost. Rather, it would be necessary to adjust the calculation of the economic benefit available from reductions in future contributions to exclude from the future service cost the effect of recognition on a straight-line basis. If the IFRIC decides to add the issue to its agenda, the staff would like more time to analyse the issue further.

10. The staff has identified the following options on this issue:

    a. Reject the request on the grounds that IFRIC 14 is clear on the assumptions that should underlie the determination of the economic benefit available from reductions in future contributions

    b. Consider clarifying what is meant in IFRIC 14 by a stable workforce

    c. Consider amending IFRIC 14 to change the determination of the economic benefit available from reductions in future contributions

    d. Ask the Board to consider amending the requirements of IFRIC 14 when it incorporates IFRIC 14 into IAS 19 during its current project on IAS 19.

11. The staff recommends rejecting the request. The effect of the timing of voluntary contributions described in the request is not a new issue, and is an inherent part of the asset ceiling. The only question is whether the determination of the economic benefit available from reductions in future contributions is appropriate. The IFRIC discussed this at length when developing IFRIC 14, and the request provides no new information on this point that was not considered at the time.

APPENDIX A

IFRIC POTENTIAL AGENDA ITEM REQUEST

Application of IFRIC 14 to prepaid employer's contribution reserve

XXXX has the following issue we would like to request IFRIC to address, with respect to IFRIC 14 *IAS 19—The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*. It relates to the application of certain requirements of paragraph 17 of IFRIC 14 in determining the economic benefits available to an employer in the form of reductions in future premiums, when the plan assets comprise premium prepayments into the employer's contribution reserve of a pension plan.

The issue:

The issue is how to apply the requirements of paragraph 17 of IFRIC 14 to 'assume no change to the benefits to be provided by a plan in the future until the plan is amended and [to] assume a stable workforce in the future' when the plan assets comprise premium prepayments into the employer's contribution reserve of a pension plan. We believe the application of the current paragraph 17 of IFRIC 14 may under circumstances lead to counterintuitive results. Under certain circumstances any voluntary payment made into voluntary employer's contribution reserve would be immediately recognised as an expense (or part of comprehensive income) and the entity can determine when to recognise the expense by making the voluntary payment. The Appendix illustrates this effect based on a simplified example.

Under YYYY law, refunds are not allowed and therefore an economic benefit from a pension plan in surplus may only be available as a reduction in future contributions. An employer may voluntarily make additional contributions to its pension fund. Such payments, recorded in the so-called employer contribution reserve of the pension fund, are not refundable by law, but they can be used at any time to reduce future pension premiums the employer is required to pay to the plan based upon the premiums determined by the pension plan itself and are tax deductible at the time of payment. The employer decides when the reserve can be used to offset its obligation to pay pension premiums.

In YYYY pension premiums are regulated by law, depending on the benefits granted, and among others increase with the age of active plan participants. Where the contributions increase with an ageing workforce, the requirement to consider the stable workforce may result in a mismatch in a plan with on average an older employee structure as the service costs have to be straight-lined (paragraph 67 of IAS 19).

Current practice:

In the books of the pension fund, the premium prepayments are separately recorded and shown as liabilities.

In the books of the employer, such prepayments, even if considered to meet the definition of plan asset, have been considered as a separate pension asset and shown as such in the financial statements. This treatment has been considered in accordance with paragraph 58(b)(ii) of IAS 19 because while the prepayments are not refundable, the employer has full discretion over when to use the prepayments to reduce future pension premiums.

<u>Reasons for the IFRIC to address the issue:</u>

IFRIC should address the issue as the new guidance under IFRIC 14 is not adequate with respect to this issue, and may under circumstances lead to arbitrary results. This issue is widespread, as it will arise in any situation in which a voluntary prepayment has been paid into a plan. As voluntary prepayments made by an entity are immediately recognised as an expense (or part of comprehensive income), the entity can determine when to recognise the expense and its reversal by making or utilising a voluntary payment. Given that such prepayment can be material, financial ratios can be materially impacted by their recognition, as could comparability between entities.

XXXX addressed this issue in our D19 comment letter dated 27 October 2006 in the section 'Economic benefits available as a reduction in future contributions':
'Paragraph 15 [of D19] says that future changes in work force demographics used to determine the asset should be consistent with those to determine the underlying obligation. … Our preferred approach would be management's best estimate of the future development of the plan membership. This would obviously need to be consistent with up to date budgets and forecasts and the assumptions made in other accounting areas (impairment for example).' However, the final version of paragraph 17 of IFRIC 14, which varied from the draft version, only aggravated the issue by referring to 'a stable workforce'.

Although the issue referred to in this request is very urgent in YYYY because of its widespread relevance, it is relevant outside YYYY as well to all those DB plans where employers can make discretionary additional premium payments into the plan.

We believe that financial reporting would be improved through a revision of the requirements of paragraph 17 of IFRIC 14 to avoid arbitrary impacts on earnings.

Although we appreciate that this issue may be addressed by the IAS 19 project, we believe a more immediate solution is required.

APPENDIX

The following example considers a situation where, measured as to the situation per balance sheet date, the service costs are lower than the employer's contributions. This scenario is common in YYYY for entities with, on average, an older employee structure as the service costs are straight-lined (paragraph 67 of IAS 19), while the required pension premiums increase with the age of the active participants

Actuarial variance effects are not considered in this example, as the actuarial assumptions are assumed constant through all periods.

	Year 1	Year 2	Year 3	Year 4	...
Plan Assets	242	242	242	242	...
DBO (with i= 3.5%)	-200	-200	-200	-200	...
Future service costs	21	21	21	21	
Future contributions	-22	-22	-22	-22	
Sum	-1	-1	-1	-1	
Present value (3.5%)	-28.6	-28.6	-28.6	-28.6	
Economic benefit available*	0	0	0	0	
Employer's contribution reserve (Payment)		8			
Employer's contribution reserve (Use)			8		

* Max (-28.6; 0) =0

For the sake of simplicity, the application of paragraph 20 of IFRIC 14 in Year 3 is based on a simplified formula of paragraph 20 of IFRIC 14 using the present value of the difference of the service costs and the expected annual contributions based on a stable workforce and on the actuarial assumptions as per the balance sheet.

Illustration of the accounting treatment under the application of IFRIC 14

The prepaid contribution of 8 made in Year 2 is factored in the calculation of the economic benefit available as per IFRIC 14.
(under the assumption that the entity maximizes the economic benefits and uses the prepayment in the next year)

	Year 1	Year 2	Year 3
Plan Assets	242	250	242
- of which premium prepayments in the Employer's contribution reserve	0	8	0
DBO	200	200	200
Excess	42	50	42
Parameters to calculate the economic benefits according to par. 58b of IAS 19 without considering prepayments into the employer's contribution reserve:			
-Future service costs	21	21	21
-Future employer's contributions	-22	-22	-22
-Sum	-1	-1	-1
Net present value of benefit discounted with 3.5%	**0**	**0**	**0**
Prepaid pension contribution	0	8*	0**
Contribution reserve not meeting criteria of asset	0	8	0
Contribution reserve meeting criteria of asset	0	0	0
Total Pension Assets	**0**	**0**	**0**
EBIT before pension asset adjustment	200	200	200
Influence from pension asset	0	-8	8
EBIT after pension asset adjustment	200	**192**	208

* An employer contribution is paid in Year 2
** The prepaid contribution is used in Year 3

The calculation of the pension asset in Year 2 can be illustrated as follows:

Plan Assets						250
DBO (i = 3.5%)						-200
Surplus						50
Limitation according to IAS 19.58b						-50
Pension Asset						**0**
	Year 3	Year 4	Year 5	Year 6	...	Present Value (3.5%)
Service costs	21	21	21	21		600
Contributions	-22	-22	-22	-22		-628.6
Employer's contribution reserve	8	-	-	-		
Total contributions	-14	-22	-22	-22		
	7					-20.6
Economic benefit available						Max (-20.6 ; 0) =0

Illustration of the accounting treatment under the common practice

The premium prepayments in the employer's contribution reserve are considered as a separate prepaid asset, not part of the IFRIC 14.20 analysis.

	Year 1	Year 2	Year 3
Plan Assets	242	250	242
- of which premium prepayments in the Employer's contribution reserve	0	8	0
DBO	200	200	200
Excess	42	50	42
Parameters to calculate the economic benefits according to par. 58b of IAS 19 without considering prepayments into the employer's contribution reserve:			
-Future service costs	21	21	21
-Future employer's contributions	-22	-22	-22
-Sum	-1	-1	-1
Net present value of benefit discounted with 3.5%	**0**	**0**	**0**
Prepaid pension contribution	0	8*	0**
Contribution reserve not meeting criteria of asset	0	0	0
Contribution reserve meeting criteria of asset	0	8	0
Total Pension Assets	**0**	**8**	**0**
EBIT before pension asset adjustment	200	200	200
Influence from pension asset	0	0	8
EBIT after pension asset adjustment	200	**200**	208

* An employer contribution is paid in Year 2

** The prepaid contribution is used in Year 3

The calculation of the pension asset in Year 2 can be illustrated as follows:

Plan Assets						250
DBO (i = 3.5%)						-200
Surplus						50
Limitation according to IAS 19.58b						-42
Pension Asset						**8**
	Year 3	Year 4	Year 5	Year 6	...	Present Value (3.5%)
Service costs	21	21	21	21		600
Contributions	-22	-22	-22	-22		-628.6
Sum	-1	-1	-1	-1		-28.6
Employer's contribution reserve	8					+8
Economic benefit available						Max (-28.6 ; 0) +8 = 8

Summary of the effect on the EBIT

	Year 1	Year 2	Year 3
Impact on financial reporting under the application of IFRIC 14			
EBIT before pension asset adjustment	400	400	400
Influence from pension asset	0	-8	8
EBIT after pension asset adjustment	400	**392**	408
Impact on financial reporting under the current practice			
EBIT before pension asset adjustment	400	400	400
Influence from pension asset	0	0	0
EBIT after pension asset adjustment	400	**400**	400

The example shows that factoring the prepaid contribution into the formula of paragraph 20 of IFRIC 14 increases the expense due to the effect of the limitation of the plan assets as per paragraph 58b of IAS 19 in Year 2 and increases the earnings in Year 3 when used. It remains at the full discretion of the employer to decide when to use the prepaid contribution reserve. As far as the application of the formula of paragraph 20 of IFRIC 14 does not result in an asset, the entity will record an income when using the reserve.

Conversely, when the premium prepayments made in the employer’s contribution reserve are valued as a separate plan asset, changes in the limitation of paragraph 58b of IAS 19 do not have any impact on earnings.

The reason these different treatments arise is because the requirement of paragraph 17 of IFRIC 14 to consider a stable workforce results in a mismatch in a situation where the contributions increase with an aging workforce.