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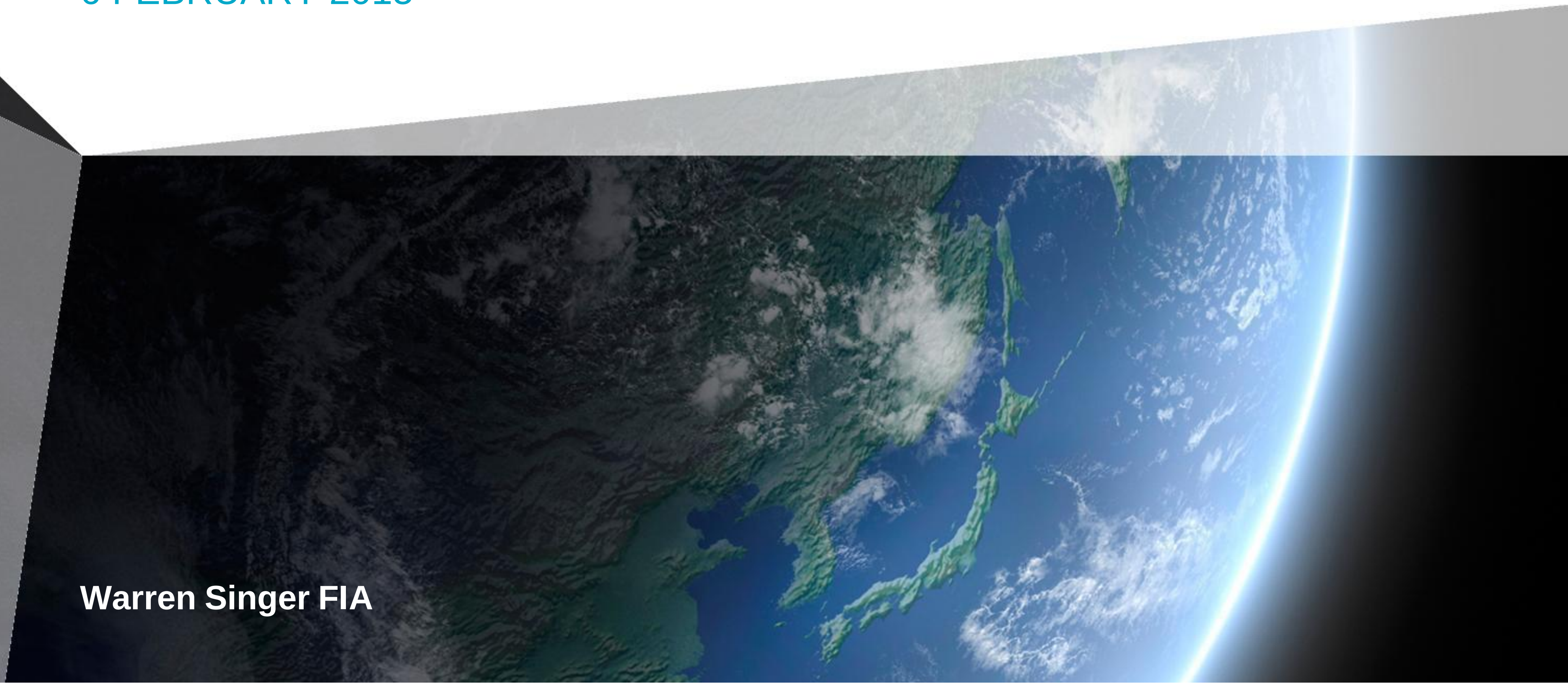
CURRENT ISSUES IN COMPANY ACCOUNTING

ACA MEMBERS' GATWICK CONFERENCE 2015

6 FEBRUARY 2015



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Agenda

Revised UK GAAP	• FRS 101 and FRS 102
Surplus recognition	• IASB attempts to clarify IFRIC 14 in the UK
Split discount rates	• Emerging practice in the UK
IAS 19 - what next?	• IFRS research projects for 2015

Revised UK GAAP
Overview

Affects all accounting – not just pensions

FRS 100 sets out new framework

Applies for accounting periods commencing on or after 1 January 2015

FRS 101 is exactly like IAS 19 for pensions

FRS 102 is a simple version of IAS 19 (with some differences)

Revised UK GAAP
Key changes for pensions under FRS 101 or FRS 102

Both follow the approach of IAS 19 in recognising pension costs:

P&L	1. Service Cost	Current service cost + past service cost (including curtailments) + settlements
P&L	2. Net Interest Cost	Interest on net benefit liability/(asset) = discount rate multiplied by net benefit liability (asset), after application of asset ceiling
OCI	3. Re-measurement cost	Gains and losses, including from routine settlements + any change in asset ceiling

Revised UK GAAP
Areas of uncertainty under FRS 101 or FRS 102

Administration costs charged to P&L separately (as an operating charge)?

Surplus recognition rules less strict than for FRS 17, so plans closed to future accrual may be able to recognise surplus as an asset (with less prescription under FRS 102)?

FRED 55: minimum funding requirements treated differently under FRS 101 and FRS 102?

FRS 17 multi-employer exemption no longer exists – UK GAAP costs need to be recognised somewhere?

Revised UK GAAP
Pension expense changes – example

- Closed to future accrual, no service cost
- DBO=10,000; discount rate = 4%
- Assets = 12,000; EROA = 6%
- Minimum funding requirement has a present value of 1,000
- FRS 17 admin expenses allowed for within Expected rate of Return on Assets
- FRS 17 surplus cap restricts balance sheet and P&L to zero. Treatment of surplus under FRS 101 and FRS 102 is uncertain – one possible view is shown

Old FRS 17	
Balance sheet asset	**0**
Service Cost	0
Interest Cost	400
Expected Return on assets	(400)
Pension Expense	**0**

New UK GAAP	FRS101	FRS102
Net DB asset/(liab)	**(1,000)**	**2,000**
Service Cost	0	0
Net Interest Cost	40	(80)
Admin Expenses	100	100
Pension Expense	**140**	**20**

Question to today's audience

Do you understand how to apply IFRIC 14 in practice, including when an entity has an unconditional right to a refund and how to recognise onerous minimum funding requirements?

A. Yes.

B. No.

Surplus recognition – IAS 19/IFRIC 14

IAS 19 (rev 2011) para 65

*"An entity recognises a net defined benefit asset… because…
the entity controls a resource, which is the ability to use the surplus…; and
future economic benefits are available to the entity in the form of a reduction in future contributions or a cash refund…The asset ceiling is the PV of those future benefits."*

IFRIC 14 para 11

"A refund is available to an entity only if the entity has an unconditional right to a refund… assuming the gradual settlement of the plan liabilities over time until all members have left the plan."

IFRIC 14 para 12

"If the entity's right to a refund of a surplus depends on the occurrence or non-occurrence of one or more uncertain future events not wholly within its control, the entity does not have an unconditional right to a refund and shall not recognise an asset"

Surplus recognition – IAS 19/IFRIC 14
When is a defined benefit plan surplus available as a refund?

- Should an asset be recognised if the employer can be prevented from getting economic benefit from the surplus because the UK trustee has a unilateral power to either:

  1. Wind up the plan
  2. Augment benefits
  3. Purchase annuities/do a “buy-in”

- IFRS Interpretations Committee considered this in 2014 and provided recommendations to the IASB, which were discussed in January 2015

Surplus recognition – IAS 19/IFRIC 14
Right to a refund of surplus

IASB tentatively agreed to a “narrow scope” amendment to IFRIC 14 to clarify:

- You don’t recognise a surplus if the trustee has the unilateral power to use the surplus for other purposes (e.g. to enhance benefits for plan members).

- You don’t have an unconditional right to a refund at the end of the life of a plan if the trustee can unilaterally decide to wind up the plan and prevent a gradual settlement.

BUT

- A trustee’s unilateral power to buy annuities or make other investment decisions without changing the pension promise is a power to make investment decisions and thus is different from the power to wind up a plan by settling plan liabilities, or the power to use a surplus to enhance benefits.

Surplus recognition – IAS 19/IFRIC 14
Impact of asset ceiling on plan amendments, curtailments or settlements

Question

If you have an unrecognised surplus (i.e. an off balance sheet asset) can you use it to "extinguish" costs due to plan amendments, curtailments or settlements that would otherwise be charged to P&L?

FRS 17 para 67b

"the unrecognised surplus should be applied to extinguish past service costs or losses on settlements or curtailments that would otherwise be charged in P&L"

IAS 19 para 109

Settlement cost is defined as the difference between the defined benefit obligation being settled and the settlement price, including any **plan assets transferred** and any payments made directly by the entity

Are the "**plan assets transferred**":

- the full value of the assets (before any asset limitation) or
- the recognised value of those assets (after an asset limitation)?

Surplus recognition – IAS 19/IFRIC 14
Impact of asset ceiling on plan amendments, curtailments or settlements

- IASB tentatively agreed in January 2015 to a “narrow scope” amendment to IAS 19 to clarify that an unrecognised surplus should NOT extinguish P&L charges:
  - when a plan amendment, curtailment or settlement occurs: a gain or loss on settlement or past service cost should be calculated and recognised in profit or loss; and
  - an entity should reassess the asset ceiling to be applied to the updated surplus and the adjustment to the asset ceiling should be recognised in other comprehensive income

Split Discount Rates

- Basis for determining discount rate under IAS 19
  - High quality corporate bond yield curve at reporting date (usually)
  - Must reflect estimated timing of benefit payments
- Traditional approach followed in the past
  - Set discount rate based on yield curve and benefit payments attributed to past service to determine the Defined Benefit Obligation (DBO)
  - Use same discount rate to determine the current service cost (SC) even though the timing of the benefit payments can be materially different
    - E.g. plan could have an average duration of 15 years with respect to past service and an average duration of 25 years for current service benefits
- Split discount rate approach aims to be more precise
  - Set discount rate for SC based on same yield curve as DBO but reflect timing of benefit payments attributed to next year service

Split Discount Rates
Example: DBO at 31.12.2014

- The DBO as at 31.12.2014 is as follows
  – DBO derived by discounting the cash flows with the spot rates

Year	Cash flows - Pensioners benefits	Cash flows - Actives benefits attributed to past service	Spot Rates
2015	0	500	1.00%
2016	1,000	450	1.25%
2017	0	250	1.50%
2018	0	150	1.75%
2019	0	50	2.00%
Total DBO 31.12.2014	**2,334**		
Single weighted average discount rate	**1.36%**		

Split Discount Rates
Example: 2015 Service Cost (SC)

- The 2015 SC derived by discounting the cash flows attributed to the 2015 service according to two methodologies:

Year	TRADITIONAL APPROACH: Cash flows discounted using the total DBO discount rate		SPLIT DISCOUNT RATE APPROACH: Cash flows discounted using the spot rate curve	
2015	0	1.36%	0	1.00%
2016	150	1.36%	150	1.25%
2017	250	1.36%	250	1.50%
2018	300	1.36%	300	1.75%
2019	350	1.36%	350	2.00%
Total SC valued at 31.12.2014	**997**		**982**	
Single weighted average discount rate	**1.36%**		**1.77%**	

Split Discount Rates
Example: DBO at 31.12.2015

- As at 31.12.2015, the actual DBO is as follows
  – DBO derived by discounting the cash flows with the same spot rates as those assumed at the beginning of the year
  – For example, a cash flow that was discounted at 1.5% per year remains discounted at 1.5% per year

Year	Cash Flows[1]	Spot Rates
2016	1,600	1.25%
2017	500	1.50%
2018	450	1.75%
2019	400	2.00%
Total DBO 31.12.2015	**2,862**	
Single weighted average discount rate	**1.63%**	

(1) Includes cash flows for pre-2015 service and 2015 service

Split Discount Rates
Example: Summary of DBO and Service Cost (SC)

	Amount	Single Equivalent Discount Rate	Comments
DBO 31.12.2014	2,334	1.36%	DBO based on cash flows discounted with spot rate curve
2015 SC			
• Traditional approach	997	1.36%	
• Split discount rate approach	982	1.77%	SC based on cash flows discounted with same spot rate curve used for DBO 31.12.2014
DBO 31.12.2015	2,862	1.63%	DBO based on updated cash flows at end of 2015 and discounted with same spot rates as those assumed at 31.12.2014

Split Discount Rates
Example: Roll forward of DBO from 31.12.2014 to 31.12.2015

	Traditional Approach		Split Discount Rate Approach	
DBO @ 31.12.2014	2,334	@ 1.36%	2,334	@ 1.36%
2015 SC (with interest)	1,011	@ 1.36%	**1,000**	@ **1.77%**
Net interest cost	32	@ 1.36%	32	@ 1.36%
Benefit payments	(500)		(500)	
Rolled Forward DBO 31.12.2015	2,877	@ 1.36%	2,866	
DBO 31.12.2015	2,862	@ 1.63%	2,862	@ 1.63%
Loss (gain)	(15)		(4)	

- Traditionally, assuming no change in the single equivalent discount rate from the beginning of the year to the end of the year, the DBO at the end of the year is set equal to the rolled forward DBO
- As shown above, a gain is created using the traditional approach since the traditional approach roll forward does not reflect the move along the yield curve, but rather assumes a shift in the yield curve
- This gain is significantly reduced by using the split discount rate approach i.e. by discounting the service cost cash flows with the spot rate yield curve
- One could argue that the assumed spot rates at 31.12.2015 should even be higher if forward rates remained as expected → that scenario results in the same conclusion

IAS 19 – What next?

IAS 19 review as a tale of two phases…

“Quick fix” by 2013 (started in 2008/9)…

Recognition

Expense

Disclosure

…later (2016 onwards?)

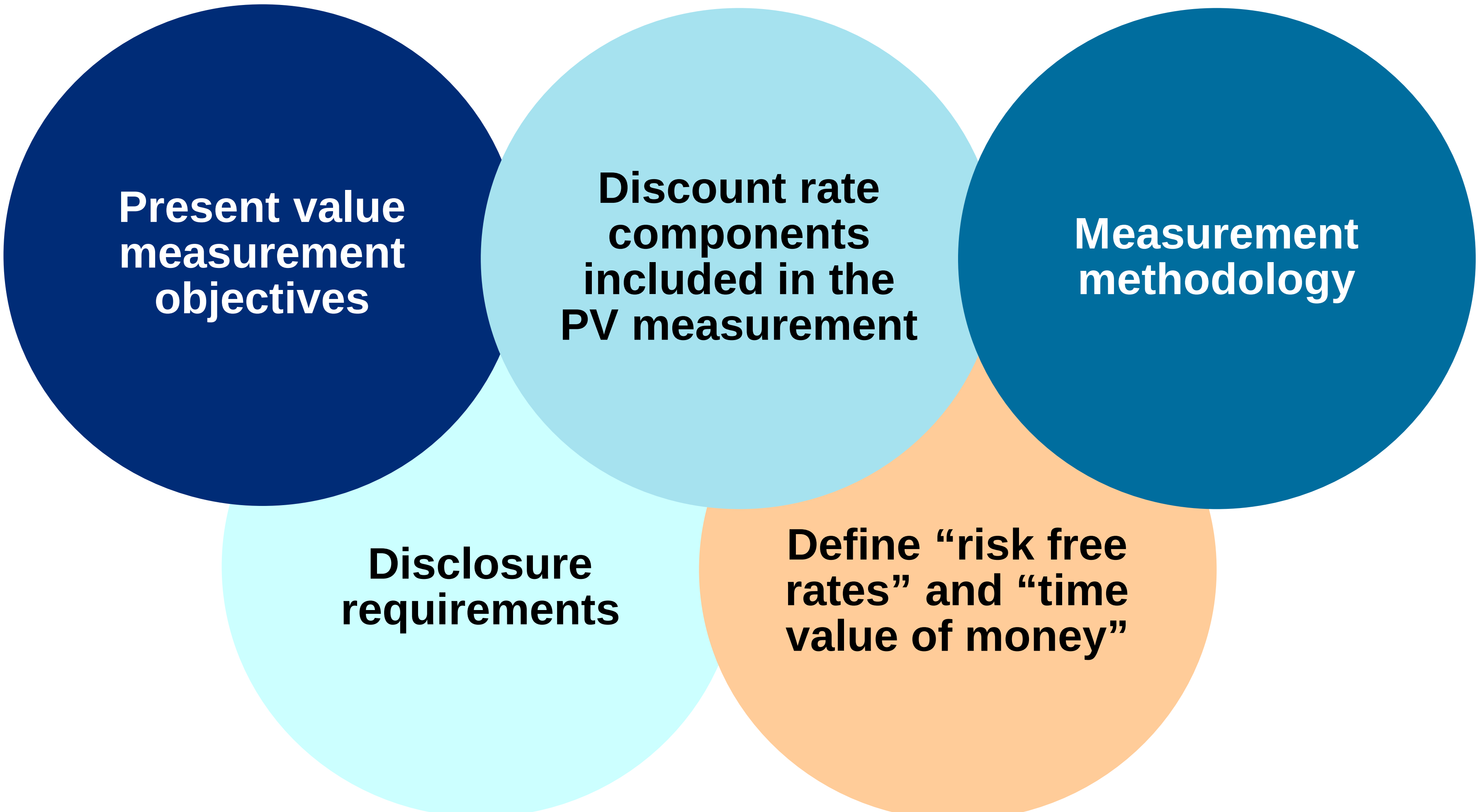
Fundamental Review

Attribution

Measurement

IAS 19 – What next?

IFRS Discount Rate Research Project – due for completion in Q1 of 2015



Identify any issues or inconsistencies between standards and propose a way forward

IAS 19 – What next?
IFRS Post employment benefits research project

Research paper to be published during 2015

- *What is a conceptually sound and robust measurement model for pension plans?*
- *Discount rates and attribution of benefits could be included*
- *To assess whether and when a fundamental revision would be appropriate given costs and benefits*

Difficulty in changing

"The current measurement has survived mainly because of its current operationality, while fair value for employee benefit liabilities is usually unavailable" (IFRS Dec 2014)

What next?

- *In about 2016, IASB is scheduled to have a post-implementation review of the 2011 revisions to IAS 19*
- *IASB may instead agree to review IAS 19 through research work, if more effective*
- *A Discussion Paper may be published at a later stage if enough evidence is identified to consider a fundamental amendment to IAS 19*

IAS 19 – What next?
Question to today's audience

Do you think that the discount rate used for IAS 19 will fundamentally change in the next 5-10 years?

A. Yes.

B. No.

QUESTIONS

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