DEPARTMENT OF TRADE AND INDUSTRY

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COMPANIES ACT, 2008 (Act 71 of 2008)

FINANCIAL REPORTING PRONOUNCEMENT 4 THE LIMIT ON A DEFINED BENEFIT ASSET, MINIMUM FUNDING REQUIREMENTS AND THEIR INTERACTION UNDER INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) IN THE SOUTH AFRICAN PENSION FUND ENVIRONMENT

I Dr Rob Davies, Minister of Trade and Industry in consultation with the Financial Reporting Standards Council, under section 204 of the Companies Act, 2008 (Act 71 of 2008), hereby publish the draft Financial Reporting Pronouncement (FRP) as a guide in terms of section 29(3) of the Act.

Interested persons may submit written comments on the proposed Amendment Regulations not later than thirty (30) days from the date of publication of this notice to:

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or

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Dr Rob Davies, MP
Minister of Trade and Industry
24 November 2017

FINANCIAL REPORTING PRONOUNCEMENT 4

THE LIMIT ON A DEFINED BENEFIT ASSET, MINIMUM FUNDING REQUIREMENTS AND THEIR INTERACTION UNDER IFRS IN THE SOUTH AFRICAN PENSION FUND ENVIRONMENT

Issued XXX 2017

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PREFACE

Financial Reporting Pronouncement 4 (FRP 4) has been issued by The Financial Reporting Standards Council (FRSC). It is applicable to companies within the ambit of the Companies Act 71 of 2008 applying International Financial Reporting Standards (IFRS).

This FRP provides guidance under IFRS on the application of IFRIC 14 – IAS 19 – *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* in South Africa in relation to defined benefit pension obligations (governed by the Pension Funds Act, 1956 (the Act)) within the scope of IAS 19 – *Employee Benefits*. Accordingly, this FRP applies to the employer entity and not to the pension fund. This FRP should be read together with IFRIC 14 and IAS 19.

FRP 4 only focuses on the following issues:

- What are minimum funding requirements?
- When should refunds be regarded as available in accordance with the definition of the asset ceiling in paragraph 8 of IAS 19 and how should they be measured?
- When should reductions in future contributions be regarded as available in accordance with the definition of the asset ceiling in paragraph 8 of IAS 19 and how should they be measured? And
- When would minimum funding requirements give rise to an additional liability?

There is no equivalent pronouncement for entities applying IFRS for SMEs because IFRS for SMEs does not contain an equivalent to IFRIC 14.

With reference to Preface to Financial Reporting Pronouncements and Guides issued by the FRSC, the FRSC may issue Financial Reporting Pronouncements (FRPs) to provide authoritative guidance to preparers, auditors and users of financial statements, thus facilitating the standardization of financial reporting.

This FRP has the same authority as IFRS.

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Paragraph .16 of IAS 1 – Presentation of Financial Statements, requires an entity whose financial statements comply with IFRSs to make an explicit and unreserved statement of such compliance in the notes. Financial statements shall not be described as complying with IFRSs unless they comply with all the requirements of IFRSs. Paragraph .7 states that assessing whether an omission or misstatement could influence economic decisions of users, and so be material, requires consideration of the characteristics of those users.

References

a) IFRIC 14 – IAS 19 – *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*

b) IAS 8 – *Accounting Policies, changes in Accounting Estimates and Errors*

c) IAS 19 – *Employee Benefits*

d) Pension Funds Act, 1956

e) Circular PF No. 66 – *Section 18 of the Pension Funds Act, 1956: Fund not in a sound financial condition*

Background

1. The Accounting Practices Board (APB) issued AC 504– *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction in the South African Pension Fund Environment* in October 2010 as a local interpretation. Following the withdrawal of Statements of Generally Accepted Accounting Practice (GAAP) in 2012, SAICA issued the local interpretation as Financial Reporting Guide 3 after making necessary revisions to reflect the changes made to IFRIC 14 and IAS 19 in 2011. The Financial Reporting Standards Council (FRSC) has considered the content of this Guide and has issued it as a Financial Reporting Pronouncement (FRP).

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2. FRP 4 has been issued to provide guidance on the application of IFRIC 14 – *IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* in South Africa in relation to a defined benefit pension obligations (governed by the Pension Funds Act, 1956 (the Act) within the scope of IAS 19 – *Employee Benefits*. Accordingly, this FRP applies to the employer entity and not to the pension fund.

3. FRP 4 should be read together with IFRIC 14 and IAS 19.

4. Paragraph 63 of IAS 19 requires an entity to recognise the net defined benefit (pension) liability/asset in the statement of financial position.

5. The net defined benefit liability/asset is the deficit or surplus adjusted for any effect of applying the asset ceiling limit.

6. The deficit or surplus is:

   a. The present value of the defined benefit obligation less

   b. The fair value of plan assets

7. The asset ceiling is defined as the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

8. IFRIC 14 provides guidance on the following issues:

   - When refunds or reductions in future contributions should be regarded as 'available' in accordance with the definition of the asset ceiling.
   - How a minimum funding requirement might affect the availability of reductions in future contributions.
   - When a minimum funding requirement might give rise to an additional liability.

9. Section 16 of the Act requires the financial condition of a fund to be determined (at a minimum) every three years by a qualified actuary. Such valuations are known as statutory valuations. Statutory valuations are also used as the basis for determining the level of contributions. For the purpose of this FRP, any deficits arising from such valuations are referred to as 'statutory deficits' and any surpluses as 'statutory surpluses'. The valuation is performed in terms of section 16 of the Act and Professional Guidance Note 201 issued by the Actuarial Society of South Africa.

10. The present value of the defined benefit obligation determined in accordance with IAS 19 less the fair value of the plan assets, if positive, is referred to as the 'accounting deficit' and, if negative, is referred to as the 'accounting surplus' for the purpose of this FRP.

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11. The requirements for determining the accounting deficit or surplus may not necessarily be the same as the requirements and guidelines used in determining the statutory deficit or surplus. The main reason for the differences stems from the fact that the IAS 19 valuation reflects the financial position of the fund at a point in time, while the purpose of the statutory valuation is to determine the appropriate level of funding for the long-term pension obligation.

12. Given the long-term nature of the obligation and the variables which may affect the amount and timing of the cash outflows as well as the variables which may affect the amount and timing of the cash inflows of the assets of the fund, the net financial position may fluctuate quite significantly over time. This could result in fluctuating contribution levels. To achieve a more stable contribution level, the Act permits certain reserves to be created in the determination of the statutory deficit or surplus.

    Such reserves may include solvency reserves; contingency reserves; contribution reserves; and data, risk and processing error reserves. The determination of the accounting deficit or surplus is set out in paragraph 10 of this FRP. IAS 19 does not permit the recognition of liabilities for such reserves, nor does it permit the plan assets to be measured at an amount other than fair value.

13. As a result of the above, the accounting deficit or surplus may be quite different from the statutory deficit or surplus. This FRP focuses on the accounting deficit or surplus[1] since this amount forms part of the net defined benefit liability/asset required to be recognised in terms of paragraph 63 of IAS 19.

Scope

14. This FRP considers only defined benefit pension plans governed by the Act from the perspective of the employer.

15. The word 'employer' is used in the South African retirement funds industry to denote the 'entity' in IFRIC 14 and IAS 19. The words are used interchangeably in this FRP.

Issues

16. This FRP only focuses on the following issues in the application of IFRIC 14 by Pension Funds Act:

    i. Issue 1: What are minimum funding requirements?

[1] References to accounting deficit or surplus also include a nil position where the defined benefit obligation is equal to the fair value of the plan assets

ii. **Issue 2: When should refunds be regarded as available in accordance with the definition of the asset ceiling in paragraph 8 of IAS 19 and how should they be measured?**

In this FRP, four possible scenarios are considered to illustrate the application of IFRIC 14 in a South African context. (It is not relevant whether a surplus apportionment exercise has been completed in terms of the Pension Funds Second Amendment Act, 2001.) The scenarios are as follows:

- Scenario 1 – the rules of the fund are silent regarding statutory surplus allocations (i.e. statutory surplus allocations are made at the discretion of the trustees);
- Scenario 2 – the rules of the fund indicate that all statutory surpluses are to be allocated to the employer;
- Scenario 3 – the rules of the fund indicate that all statutory surpluses are to be allocated to the members of the fund; and
- Scenario 4 – the rules of the fund indicate that all statutory surpluses are to be allocated in a specified proportion between the employer and members of the fund (for example 60% to the employer and 40% to the members).

iii **Issue 3: When should reductions in future contributions be regarded as available in accordance with the definition of the asset ceiling in paragraph 8 of IAS 19 and how should they be measured?**

iv. **Issue 4: When would minimum funding requirements give rise to an additional liability?**

Consensus

Issue 1: Minimum funding requirements

17. As outlined in paragraph 2 of IFRIC 14: *"Minimum funding requirements exist in many countries to improve the security of the post-employment benefit promise made to members of an employee benefit plan. Such requirements normally stipulate a minimum amount or level of contributions that must be made to a plan over a given period."*

18. Paragraph 5 of IFRIC 14 states that, for the purpose of that Interpretation, *"… minimum funding requirements are* ***any requirements to fund*** *a post-*

employment or other long-term defined benefit plan." (emphasis added).

19. Paragraph 18 of IFRIC 14 requires an entity to "... *analyse any minimum funding requirement at a given date into contributions that are required to cover (a) any existing shortfall for past service on the minimum funding basis and (b) future service".*

20. In a South African pension fund context, the contributions required to "*bring the fund into a financially sound condition within a reasonable period*" in accordance with the requirements of section 18 of the Act constitute a minimum funding requirement as contemplated in paragraph 18(a) of IFRIC 14 (i.e. a minimum funding requirement to cover any existing shortfall for past service on the minimum funding basis). (The contributions being referred to here are only those which are required in order to bring the fund into a financially sound condition, i.e. they exclude any contributions which will be payable to cover future service.) This type of minimum funding requirement is relevant for the purposes of considering whether an additional liability may be required to be recognised (refer to Issue 4).

21. In a South African pension fund context, "*the contribution rate the valuator recommends be payable by the employer, taking into account the circumstances of the fund and ignoring any surplus or deficit*", as referred to in the definition of a "contribution holiday" in section 1 of the Act, constitutes a minimum funding requirement as contemplated in paragraph 18(b) of IFRIC 14 (i.e. a minimum funding requirement to cover future service). This type of minimum funding requirement is relevant in determining the availability of economic benefits in the form of reductions in future contributions (refer to Issue 3).

22. In some instances, the rules of the fund may specify the contribution rate payable by the employer. In such instances, this rate would be the minimum funding requirement to cover future service unless the contribution rate the valuator would recommend be payable is higher, in which case the higher rate would constitute such a minimum funding requirement.

23. As noted in paragraph 18 of IFRIC 14, actuaries/ valuators will be required to analyse an entity's contributions between those described in paragraph 18 (a) and (b) for the entity to be able to apply IFRIC 14.

Issue 2: Availability of an economic benefit in the form of a refund in accordance with the definition of the asset ceiling in paragraph 8 of IAS 19 and its measurement

24. Paragraph 11 of IFRIC 14 states that a "*refund is available to an entity only if the entity has an unconditional right to a refund*".

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25. The amount of any accounting surplus[2] that represents an economic benefit available as a refund is considered to be the following in the four scenarios outlined in paragraph 17(ii) of this FRP:

- Scenario 1 – The balance of any Employer Surplus Account (ESA) at the reporting date (limited to the accounting surplus) less any costs that would be incurred upon realisation.
- Scenario 2 – The accounting surplus at the reporting date less any costs that would be incurred upon realisation.
- Scenario 3 – The balance of any ESA[3] at the reporting date (limited to the accounting surplus[2]) less any costs that would be incurred upon realisation.
- Scenario 4 – The accounting surplus[2] at the reporting date less any costs that would be incurred upon realisation.

Issue 3: Availability of an economic benefit in the form of a reduction in future contributions in accordance with the definition of the asset ceiling in paragraph 8 of IAS 19 and its measurement

26. In accordance with paragraph 20 of IFRIC 14, if there is a minimum funding requirement for contributions relating to future service, the economic benefit available as a reduction in future contributions should be calculated as the sum of:

    a) any amount that reduces future minimum funding requirement contributions for future service because the entity made a prepayment (i.e. paid the amount before being required to do so); and

    b) the estimated future IAS 19 service cost to the entity in each period over the shorter of the expected life of the plan and the expected life of the entity, less the estimated minimum funding requirement contributions that would be required for future service in those periods if there were no prepayment as described in a). The future service cost to the entity excludes amounts that will be borne by employees.

27. In a South African pension fund context, prepayments of contributions for future

[2] In accordance with IAS 19 any surpluses to be allocated to the members increase the defined benefit obligation and hence result in a reduced accounting surplus. For example, if the accounting surplus is 100 before considering any allocations and the amount to be allocated to members (based on the rules and including any existing Member Surplus Account (MSA) balance) is 30, the resulting accounting surplus is 70 after consideration of such allocations. It is this amount that is being referred to when reference is made to determining the extent to which the accounting surplus is available as an economic benefit.

[3] This could be the case for example where an ESA existed at the date the rules changed to require subsequent surpluses to be allocated to the members.

services are not something that is contemplated in terms of the Act. Should an entity pay more than the contribution required to be paid in a particular year, it is most likely that such additional payment would be credited to the ESA. This is to ensure that the entity retains the right to access those funds in accordance with Section 15E (1) of the Act.

Since the Act does not contemplate prepayments of contributions for future service, it is likely that any such payments would not automatically reduce the future minimum funding requirement contributions for future service (i.e. the contribution rate recommended by the valuator). However, since the additional payment would be credited to the ESA, the entity would be able to use such amounts to take a contribution holiday. For this reason, even if there is a prepayment, the amount in paragraph 26 a) will be nil. The balance on the ESA would be taken into account in determining the economic benefit available in the form of a refund (refer to Issue 2).

28. With regard to the four scenarios outlined in Issue 2 (paragraph 16(ii)), the amount of any accounting surplus[2] that represents an economic benefit available as a reduction in future contributions for each scenario is considered to be:

- the estimated future IAS 19 service cost to the entity in each period over the shorter of the expected life of the plan and the expected life of the entity, less
- the estimated contributions that the valuator recommends be payable by the employer (taking into account the circumstances of the fund but ignoring any statutory surplus or deficit) in that year or the contributions specified in the rules if that is higher than the contributions that the valuator would otherwise have recommended.

29. Since a 'contribution holiday' as defined in section 1 of the Act, can only be taken by using amounts allocated to the employer, the benefits to the employer of a contribution holiday have in essence been taken into account in the calculation of the amount available in the form of a refund discussed under Issue 2. Therefore, the estimated contribution rate that the valuator recommends be payable (taking into account the circumstances of the fund but ignoring any statutory surplus or deficit), as referred to in paragraph 28, should ignore the effects of any contribution holiday (if any) that has been agreed to by the trustees.

Otherwise, such a benefit would be regarded as both an economic benefit available as a refund and as a reduction in future contributions which would result in a double-counting of such a benefit. Refer to paragraph 31. Alternatively, to avoid double-counting, in calculating the benefit available as a refund (refer to Issue 2), any approved contribution holiday should be taken into account by reducing the ESA.

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30. The benefit that is being calculated as the reduction in future contributions effectively represents the expected utilisation of the current accounting surplus to fund the shortfall between the present value of the future IAS 19 service cost and the present value of the minimum funding requirement for future service. For example, assume the accounting surplus is 120, the present value of the future IAS 19 service cost is 500 and the present value of the minimum funding requirement for future service is 400.

    All things being equal, in order to fund the future IAS 19 service cost, the future contributions should be 500. However, because of the surplus, the future contributions of 500 that would otherwise be required to be paid can be reduced to 400. Therefore, 100 would represent the benefit available in the form of a reduction in future contributions in accordance with paragraph 20 of IFRIC 14.

31. As noted in paragraph 9 of IFRIC 14, an entity needs to determine the maximum economic benefit that is available from refunds, reductions in future contributions, or a combination of both. It is not appropriate to consider economic benefits from a combination of refunds and reductions in future contributions based on assumptions which are mutually exclusive.

    Therefore, continuing the example in paragraph 30, if the amount available as a refund is 70 (which include any amount of the ESA to be used to take a contribution holiday), the maximum benefit would be 120 and not 170. This is because the accounting surplus is only 120, therefore it is not possible to obtain a refund of 70 and benefit from a reduction in future contributions to the extent of 100. However, if the amount available as a refund is 5 (which includes any amount of the ESA to be used to take a contribution holiday), the maximum benefit would be 105.

Issue 4: When minimum funding requirements might give rise to an additional liability

32. As noted in paragraph 19 of this FRP, minimum funding requirements need to be analysed between those that are required to cover (a) any existing shortfall for past service on the minimum funding basis and (b) future service.

33. In determining whether a minimum funding requirement may give rise to an additional liability, paragraph 23 of IFRIC 14 only considers minimum funding requirements "*to pay contributions to cover an existing shortfall on the minimum funding basis in respect of services already received*". Such minimum funding requirements are those referred to in paragraph 18(a) of IFRIC 14.

34. As noted in paragraph 20 of this FRP, when a fund is not in a financially sound condition it is required to submit a scheme to the Registrar of Pension Funds setting out the contributions which are required to be made in order to bring the fund into a financially sound condition within a reasonable period. (The

contributions being referred to here are only those which are required in order to bring the fund into a financially sound condition, i.e. they exclude any contributions which will be payable to cover future service.) Such contributions constitute a minimum funding requirement to cover an existing shortfall on the minimum funding basis in respect of services already received as contemplated in paragraph 18(a) of IFRIC 14.

35. If an entity is required to make contributions to cover an existing shortfall in respect of services already received (contributions under paragraph 18(a) of IFRIC 14), it needs to assess to what extent it will benefit from them. In other words, if the payment of such contributions would result in the creation or increase of an accounting surplus, the entity needs to determine the maximum economic benefit available as a refund, reduction in future contributions or a combination of both. This should be done following the guidance provided in IFRIC 14 and in this FRP.

36. To the extent that the contributions payable to cover an existing shortfall in respect of services already received (contributions under paragraph 18(a) of IFRIC 14) will not be available to the entity after they have been paid into the plan, the entity should recognise a liability at the reporting date. The basis for such a liability is founded on the principles of an onerous contract. The liability should reduce any net defined benefit asset or increase any net defined benefit liability (refer to paragraph 24 of IFRIC 14).

Effective Date

37. An entity shall apply this FRP for annual periods beginning on or after xxx[4].. Earlier application is permitted and encouraged. If an entity applies this FRP for an earlier period, it shall disclose that fact.

38. This FRP shall be applied retrospectively subject to the provisions of IAS 8. *Accounting Policies, changes in Accounting Estimates and Errors.*

[4] Proposed effective date is annual periods beginning on or after 1 January 2018.

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Appendix A

The following table summarises the application of the asset ceiling under IAS 19 to the four scenarios contemplated in this FRP based on the consensus reached regarding the availability of a refund or reduction in future contributions.

	Rules of the fund	Accounting surplus available as a refund	Accounting surplus available as a reduction in future contributions
Scenario 1	**Silent on the treatment of statutory surpluses (i.e. statutory surplus allocation is at the discretion of the trustees)**	ESA balance (if any) (limited to the accounting surplus) less costs of realisation	The difference in each year between the estimated IAS 19 service cost and the contribution rate recommended by the actuary/valuator
Scenario 2	**All statutory surpluses to be allocated to the employer**	Accounting surplus less costs of realisation	The difference in each year between the estimated IAS 19 service cost and the contribution rate recommended by the actuary/valuator.
Scenario 3	**All statutory surpluses to be allocated to the members of the fund**	ESA balance (if any) (limited to the accounting surplus) less costs of realisation	The difference in each year between the estimated IAS 19 service cost and the contribution rate recommended by the actuary/valuator.
Scenario 4	**Statutory surpluses to be allocated in a specified proportion between the employer and the members of the fund**	Accounting surplus less costs of realisation	The difference in each year between the estimated IAS 19 service cost and the contribution rate recommended by the actuary/valuator

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Illustrative examples

These examples accompany, but are not part of this FRP.

Example 1 – Effect of the minimum funding requirement (paragraph 18 (a) of IFRIC 14) when there is an accounting surplus and the minimum funding contributions payable are fully refundable to the entity

IE1 An entity has submitted a scheme, in accordance with the requirements of section 18 of the Act, to the Registrar of Pension Funds to bring the fund into a financially sound condition within a reasonable period. Under the minimum funding requirement, the entity has an obligation to make additional contributions to the retirement fund over the next three years to make good the deficit. The present value of those contributions amounts to 200 at the reporting date. The retirement fund rules require all statutory surpluses to be allocated to the employer. There is no Member Surplus Account (MSA). The year-end IAS 19 valuations for the retirement fund are set out below.

Fair value of plan assets	1,200
Present value of defined benefit obligation under IAS 19	(1,100)
Accounting surplus	100
Net defined benefit asset (before consideration of the minimum funding requirement)	100

Application of requirements

IE2 Paragraph 24 of IFRIC 14 requires the entity to recognise a liability to the extent that the contributions payable are not fully available. Payment of the contributions with a present value of 200 will increase the accounting surplus from 100 to 300. Under the rules of the retirement fund all statutory surpluses are required to be allocated to the employer and there is no MSA, therefore this amount would be fully refundable to the entity with no associated costs. Therefore, no liability is recognised for the obligation to pay the contributions in respect of past service. In respect of the accounting surplus, the entity would recognise a net defined benefit asset of 100 since all surpluses are required to be allocated to the employer. Hence, 100 is available as an economic benefit in the form of a refund.

Example 2—Effect of minimum funding requirements (paragraphs 18(a) and (b) of IFRIC 14) when there is an accounting deficit and the minimum funding contributions payable would not be fully available

IE3 An entity has submitted a scheme to the Registrar of Pension Funds to bring the fund into a financially sound condition within a reasonable period. Under the minimum funding requirement, the entity has an obligation to make additional contributions to the retirement fund over the next three years to make good the deficit. The present value of those contributions amounts to 300 at the reporting date.

The retirement fund rules provide for surplus allocation to the Employer Surplus Account (ESA) at the trustees' discretion. No amounts have been allocated to the ESA or MSA at the reporting date. The estimated contribution rate that the valuator would recommend taking into account the circumstances of the fund, but ignoring any statutory deficit or surplus happens to equal the future IAS 19 service cost to the entity. The year-end IAS 19 valuations for the retirement fund are set out below.

Fair value of plan assets	1,000
Present value of defined benefit obligation under	
IAS 19	(1,100)
Accounting deficit	(100)
Net defined benefit liability (before consideration of the minimum funding requirement)	(100)

Application of requirements

IE4 The payment of the contribution with a present value of 300 would change the accounting deficit of 100 to a surplus of 200. However, of this remaining 200, nothing is refundable until it has been formally allocated to the ESA. Also, the amount available as a reduction in future contributions is nil because the entity is not permitted to reduce its contributions below the contribution rate recommended by the valuator (taking account of the circumstances of the fund, but ignoring any statutory surplus or deficit), which happens to equal the future IAS 19 service cost to the entity.

IE5 Therefore, of the contributions with a present value of 300, 100 eliminate the accounting deficit, but the remaining 200 is not available as an economic benefit to the entity.

IE6 Paragraph 24 of IFRIC 14 requires the entity to recognise a liability to the extent that the additional contributions payable to fund the deficit are not available to it.

IE7 Therefore, the entity increases the net defined benefit liability by 200. No other liability is recognised in respect of the statutory obligation to pay contributions with a present value of 300 to fund the deficit.

Summary

Fair value of plan assets	1,000
Present value of defined benefit obligation under IAS 19	(1,100)
Accounting deficit	(100)
Net defined benefit liability (before consideration of the minimum funding requirement)	(100)
Adjustment in respect of minimum funding requirement	(200)
Net liability recognized	(300)

IE8 All things being equal, when the contributions with a present value of 300 are paid into the retirement fund, the net liability recognised will become 0 (300 – 300).

Example 3—Effect of a minimum funding requirement (paragraphs 18 (a) and (b) of IFRIC 14) when the contributions payable would not be fully available and the effect on the economic benefit available as a reduction in future contributions

IE9 The entity's valuator has recommended a funding level which is measured on a different basis from the service cost under IAS 19. The entity has also submitted a scheme to the Registrar of Pension Funds to bring the fund into a financially sound condition within a reasonable period. The recommended contributions are therefore required to make good the deficit on the minimum funding requirement basis (shortfall) and to cover future service.

IE10 The retirement fund has an accounting surplus at the reporting date of 50. The retirement fund rules provide for surplus allocation to the Employer Surplus Account (ESA) at the trustees' discretion. No amounts have been allocated to the ESA or MSA at the reporting date.

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IE11 The nominal amounts of the contributions required to satisfy the minimum funding requirements in respect of the shortfall and the future service for the next three years are set out below.

Year	Total contributions for minimum funding requirement	Contributions required to make good the shortfall	Contributions required to cover future service
1	135	120	15
2	125	112	13
3	115	104	11

Application of requirements

IE12 The entity's present obligation in respect of services already received only includes the contributions required to make good the shortfall. This is a minimum funding requirement under paragraph 18(a) of IFRIC 14. The recommended contributions required to cover future service constitute a minimum funding requirement under paragraph 18(b) of IFRIC 14.

IE13 The present value of the entity's defined benefit obligation in respect of services already received, assuming a discount rate of 6 percent per year, is approximately 300, calculated as follows:

$$[120/(1.06) + 112/(1.06)^2 + 104/(1.06)^3].$$

IE14 When these contributions are paid into the retirement fund, the accounting surplus (i.e. the fair value of plan assets less the present value of the defined benefit obligation) would, other things being equal, increase from 50 to 350 (300 + 50).

IE15 However, since the rules are silent on the allocation of surpluses and nothing has been allocated to the entity yet, the entity does not have an unconditional right to a refund, although the accounting surplus may be available as a reduction in future contributions.

IE16 In accordance with paragraph 20 of IFRIC 14, the economic benefit available as a reduction in future contributions is the sum of:

- Any amount that reduces future minimum funding requirement contributions for future service because the entity made a prepayment (i.e. paid the amount

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before being required to do so); and

- The estimated future service cost in each period in accordance with paragraphs 16 and 17, less
- The estimated minimum funding requirement contributions that would be required for future service in those periods if there were no prepayment as described in the first bullet point.

IE17 In this example there is no prepayment. The amounts available as a reduction in future contributions are set out below.

Year	IAS 19 service cost	Minimum contributions required to cover future service	Amount available as contribution reduction
1	13	15	(2)
2	13	13	0
3	13	11	2
4+	13	9	4

IE18 Assuming a discount rate of 6 percent per year, the present value of the economic benefit available as a reduction in future contributions is equal to:

$(2)/(1.06) + 0/(1.06)^2 + 2/(1.06)^3 + 4/(1.06)^4 + \ldots + 4/(1.06)^{50} + \ldots = 56.$

Thus, the asset ceiling, which is the present value of the economic benefit available from future contribution reductions, is 56.

IE19 Paragraph 24 of IFRIC 14 requires the entity to recognise a liability to the extent that the additional contributions payable to fund the deficit will not be fully available. Therefore, the entity reduces the net defined benefit asset by 294 (50 + 300 – 56), resulting in the recognition of a net defined benefit liability of 244 No other liability is recognised in respect of the obligation to make contributions to fund the minimum funding shortfall.

Summary

Accounting surplus	50
Net defined benefit asset (before consideration of the minimum funding requirement)	50
Adjustment in respect of minimum funding requirement	294
	19

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Net liability recognized	(244)

IE20 When the contributions with a present value of 300 are paid into the retirement fund, the net defined benefit asset recognised will become 56 (300 – 244), which represents the amount available as a reduction in future contributions, since no refund is available to the entity.

FRP 4 THE LIMIT ON A DEFINED BENEFIT ASSET, MINIMUM FUNDING REQUIREMENTS AND THEIR INTERACTION UNDER IFRS IN THE SOUTH AFRICAN PENSION FUND ENVIRONMENT

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of the FRP.

BC1 The Basis for Conclusions summarises the considerations in reaching the consensus.

Scope

BC2 The applicability of IFRIC 14 to post-retirement medical benefits (PRMB) was considered in the drafting of this FRP. In the South African environment there is no statutory requirement to fund a PRMB by transferring funds into a separate fund or entity. In some cases entities may take out insurance policies in order to fund their PRMB, but they are not required by statute to do so. There could be instances where there may be contractual requirements to fund a PRMB. In such circumstances an entity should consider the applicability of IFRIC 14. However, since it was not expected that IFRIC 14 would be relevant to all PRMB, it was decided to limit the scope of this FRP to defined benefit pension plans.

Issue 1: Minimum funding requirements

BC3 As outlined in paragraph 2 of IFRIC 14: *"Minimum funding requirements exist in many countries to improve the security of the post-employment benefit promise made to members of an employee benefit plan. Such requirements normally stipulate a minimum amount or level of contributions that must be made to a plan over a given period."*

BC4 It is necessary to know what 'minimum funding requirements' are in the South African retirement funds environment because these might require an additional liability to be recognised by the entity and/or these might affect the availability of reductions in future contributions.

BC5 Paragraph 18 of IFRIC 14 requires an entity to "... *analyse any minimum funding requirement at a given date into contributions that are required to cover (a) any existing shortfall for past service on the minimum funding basis and (b) future service".*

BC6 In terms of section 18 of the Act, when a fund is not in a financially sound condition (as clarified by Circular PF No.66), it is required to submit a scheme to the Registrar of Pension Funds, setting out the contributions which will be made to bring the fund into a financially sound condition within a reasonable period. The statutory deficit is usually required to be eliminated within three years. The minimum funding requirements are a statutory requirement and are independent of the status of the fund as determined under IAS 19. Therefore, the contributions required to bring the fund into a financially sound condition within a reasonable period constitute a minimum funding requirement as contemplated in paragraph 18(a) of IFRIC 14 (i.e. a minimum funding requirement to cover any existing shortfall for past service on the minimum funding basis).

BC7 Section 15A of the Act states that all statutory surpluses in the fund belong to the fund and that after 7 December 2001 the only portion of the assets of the fund that may be utilised by, or for the benefit of, the employer is any credit balance in the Employer Surplus Account (ESA). One possible usage of the ESA is to take a contribution holiday. A contribution holiday is defined in section 1 of the Act, for a defined benefit category of a fund, as "*the payment by the employer of less than the contribution rate the valuator recommends be payable by the employer taking into account the circumstances of the fund and ignoring any surplus or deficit.*"

Since the only way in which the employer can reduce contributions below the rate recommended by the actuary/valuator is to follow the legal route of taking a contribution holiday, the contribution rate the valuator recommends be payable by the employer to fund future service constitutes a minimum funding requirement to fund future service as contemplated in paragraph 18(b) of IFRIC 14. In instances where the rules of the fund specify the contribution rate, such a rate would be the minimum funding requirement to cover future service unless the contribution rate the valuator would recommend be payable is higher, in which case the higher rate would constitute such a minimum funding requirement.

Issue 2: Availability of an economic benefit in the form of a refund in accordance with the definition of the asset ceiling in paragraph 8 of IAS 19 and its measurement

BC8 Paragraph 11 of IFRIC 14 states that a "*refund is available to an entity only if the entity has an unconditional right to a refund*".

BC9 In terms of section 15A of the Act, all statutory surpluses in the fund belong to the fund. However, the employer acquires certain rights to the statutory surplus that has been allocated to the ESA.

BC10 Any statutory surplus in a fund at the surplus apportionment date (as specified in terms of section 15B of the Act) is required to be apportioned between stakeholders. The Act specifies the process to be followed to determine the allocation but does not specify the amount to be allocated to each stakeholder. This may result in an amount being allocated to the ESA by the trustees of the fund.

BC11 The apportionment of any statutory surplus arising after the surplus apportionment date between the ESA and Member Surplus Account (MSA) is determined in accordance with the rules of the fund and section 15C of the Act. It should be noted that all amendments or additions to the rules of a fund require the approval of the Registrar of Pension Funds. If the rules are silent, the fund's board of trustees would determine the apportionment at its own discretion.

BC12 The statutory surplus allocated to the ESA (either in terms of the rules or as determined by the trustees) may be used by the employer for the following purposes, as set out in section 15E (1) of the Act:

(a) funding a contribution holiday (refer to paragraph 19 above, for the definition of a contribution holiday);

(b) payment of pensions, or an increase in pensions in course of payment, so as to compensate members for the loss of any subsidy from the employer of their medical costs after retirement;

(c) meeting, in full or in part, expenses which the employer is obliged to pay in terms of the rules of the fund;

(d) improving the benefits payable to all members, or a category of members as defined in the rules, as determined by the employer;

(e) transferring part, or all, of the ESA in terms of section 15E(2) of the Act to the ESA in another fund where the employer is a participating employer;

(f) on liquidation of the fund in terms of sections 28 or 29, payment in cash to the employer in terms of section 15I;

(g) in order to avoid retrenchment of a significant proportion of the workforce, payment in cash to the employer in terms of section 15J; and

(h) transferring part, or all, of the ESA to the MSA in the same fund.

BC13 Applying the above to each of the four scenarios outlined in Issue 2, the amount of any accounting surplus that represents an economic benefit available as a refund is considered to be the following:

- Scenario 1 – The balance of any ESA at the reporting date (limited to the accounting surplus) less any costs that would be incurred upon realisation. This is because the entity has an unconditional right to access only the amount in the ESA. Since the trustees need to determine the allocation of the surplus, until an amount has been allocated to the ESA, the entity does not have an unconditional right to that amount. In addition, if it so happens that there is an unallocated surplus upon liquidation of a fund, the entity will only be entitled to the amount in the ESA at that date. The unallocated surplus would need to be allocated by the liquidator to the members who left within 12 months prior to liquidation.
- Scenario 2 – The accounting surplus less any costs that would be incurred upon realisation. This is because the rules require all statutory surpluses to be allocated to the employer. Although the statutory surplus might be different from the accounting surplus at the reporting date for the reasons

given in paragraphs 11 to 13 of this FRP, the accounting surplus should be used. From an accounting perspective, the accounting surplus reflects the best estimate, at the reporting date, of the statutory surplus that will exist in the plan assuming the gradual settlement of plan obligations over time until all members have left. Given that the rules require all statutory surpluses to be allocated to the employer, the employer has an unconditional right to a refund equal to the accounting surplus. As discussed in the footnote 2 on page 10, the accounting surplus being referred to is the amount of the surplus *after* any allocations of surpluses to the members.

- Scenario 3 – The balance of any ESA at the reporting date (limited to the accounting surplus) less any costs that would be incurred upon realisation. There may have been an amount allocated to the ESA as a result of the first surplus apportionment after the surplus apportionment date. In this scenario the rules require all statutory surpluses arising after surplus apportionment to be allocated to the members, with the result that no refund (other than that which may have been allocated to the ESA) is available to the entity.

- Scenario 4 – The accounting surplus less any costs that would be incurred upon realisation. As discussed in the footnote 2 on page 10, the accounting surplus being referred to is the amount of the surplus *after* any allocations of surpluses to the members.

Issue 3: Availability of an economic benefit in the form of a reduction in future contributions in accordance with the definition of the asset ceiling in paragraph 8 of IAS 19 and its measurement

BC14 IFRIC 14, BC17 states that the amount of the contribution reduction available to an entity should be measured with reference to the amount that the entity would have been required to pay had there been no accounting surplus. The IFRIC believes that this is represented by the future IAS 19 service cost to the entity.

BC15 In terms of paragraph 16 of IFRIC 14, if there is no minimum funding requirement for contributions relating to future service the economic benefit available as a reduction in future contributions is:

- the future IAS 19 service cost to the entity for each period over the shorter of the expected life of the plan and the expected life of the entity._The future service cost to the entity excludes amounts that will be borne by employees.

BC16 In terms of paragraph 20 of IFRIC 14, if there is a minimum funding requirement for contributions relating to future service, the economic benefit available as a reduction in future contributions is the sum of:

a) Any amount that reduces future minimum funding requirement contributions for future service because the entity made a prepayment (i.e. paid the amount before being required to do so); and

b) The estimated future IAS 19 service cost to the entity in each period over the shorter of the expected life of the plan and the expected life of the entity, less the estimated minimum funding requirement contributions for future service in those periods if there were no prepayment described in a).

BC17 As concluded in paragraph BC7, the contribution rate the valuator recommends be payable by the employer to fund the future accrual of benefits, taking into account the circumstances of the fund and ignoring any surplus or deficit, or if higher, any rate specified in the rules, constitutes a minimum funding requirement in respect of future services as contemplated in paragraph 18(b) of IFRIC 14.

BC18 In terms of paragraph 22 of IFRIC 14 "*When an entity determines the amount described in paragraph 20(b), if the future minimum funding requirement contributions for future service exceeds the future IAS 19 service cost in any given period, that excess reduces the amount of the economic benefit available as a reduction in future contributions. However, the amount described in paragraph 20(b) can never be less than zero.*"

BC19 The IFRIC considered whether an asset should be recognised in respect of reductions in future contributions only to the extent that there was a formal agreement between the trustees and the entity specifying contributions payable lower than the future IAS 19 service cost. The IFRIC did not agree with this and concluded that "*...an entity is entitled to assume that, in general, it will not be required to make contributions to a plan in order to maintain a surplus and hence that it will be able to reduce contributions if the plan had a surplus.*" (Refer to paragraph BC18 of IFRIC 14.)

BC20 With regard to prepayments of contributions for future service, these are not contemplated in the Act. Should an entity pay more than the contribution required to be paid in a particular year, it is most likely that such additional payment would be credited to the ESA. This is to ensure that the entity retains the right to access those funds in accordance with Section 15 E(1) of the Act. Since the Act does not contemplate prepayments of contributions for future service, it is likely that any such payments would not automatically reduce the future minimum funding requirement contributions for future service (i.e. the contribution rate recommended by the valuator). However, since the additional payment would be credited to the ESA, the entity would be able to use such amounts to take a contribution holiday. For this reason, even if there is a prepayment, the amount in paragraph 20(a) of IFRIC 14 will be nil. The balance on the ESA would be taken into account in determining the economic benefit available in the form of a refund (refer to Issue 2).

BC21 The amount of any accounting surplus that represents an economic benefit available as a reduction in future contributions is therefore considered to be the following for all four scenarios:

The difference between the estimated future IAS 19 service cost to the entity and the estimated contributions that the valuator would recommend be payable by the employer (taking into account the circumstances of the fund but ignoring any statutory surplus or deficit), or, if higher, any contributions payable as specified in the rules, in each period (over the shorter of the expected life of the plan and the expected life of the entity). This is because the employer is only required to pay the contributions recommended by the valuator (or the contributions specified in the rules) and not the IAS 19 service cost.