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International Accounting Standards Board

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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: **January 2008, London**

Project: **IAS 19 – *Employee Benefits* Settlements (Agenda Paper 7A)**

Issue

1. The IFRIC received a request to clarify whether some payments of benefits under a defined benefit plan are settlements as defined in IAS 19. The payments in question arise when a plan gives plan members the option to receive a lump sum payment at retirement instead of ongoing payments. The request is reproduced in Appendix A.

2. Whether the payments are treated as settlements or not matters because of the way in which settlements are accounted for under IAS 19. When a plan gives the option of a lump sum settlement or ongoing annual payments, the measurement of the defined benefit obligation will be based on the best estimate of how many employees will take each option. Then when a lump sum payment is made:

    a. if the payment of any lump sum is *not* treated as a settlement, any gain or loss arising because actual experience differs from the best estimate will be treated as an actuarial gain or loss.[1] Under IAS 19, it may be recognised in profit or loss, deferred, or recognised in other comprehensive income depending on the entity's accounting policy for actuarial gains and losses

b. if the payment of a lump sum *is* treated as a settlement, any gain or loss arising because actual experience differs from the best estimate will be recognised immediately in profit or loss.[2] In addition, a portion of any accumulated unrecognised gains and losses will also be recognised immediately in profit or loss. It is this latter requirement that can make a substantial difference between the two approaches.

Staff analysis

3. Paragraph 112 of IAS 19 Employee Benefits defines a 'settlement' as follows: "A settlement occurs when an entity enters into a transaction that eliminates all further legal or constructive obligation for part or all of the benefits provided under a defined benefit plan, for example, when a lump-sum cash payment is made to, or on behalf of, plan participants in exchange for their rights to receive specified post-employment benefits."

4. The following paragraphs set out arguments for lump sum payments of the type in question being covered, or not, by this definition.

View A – not a settlement

5. The IASB staff with pension accounting experience (including those who originally drafted IAS 19) expressed an instinctive view that settlements were intended to be 'special' events, not just part of the normal running of the plan. Hence, if the payments were part of the expected running of the plan, they would not be regarded as settlements. The staff acknowledges that the words in IAS 19 do not provide clear or conclusive support for such a view, although some point to the words 'an entity *enters into a transaction*' as giving some such indication. That is, many people would not view an action that is provided for as part of the terms of the plan as "entering into a transaction". The transaction was the pension

[1] There may be no gain or loss if the lump sum equals the present value of the expected annual payments that would otherwise be made.

[2] Again, there may not be any such gain or loss.

promise made to the employee in return for services which could be settled in one of two ways.

6. This is also supported by guidance from the two of the manuals published by the large accounting firms. One states:

> A settlement is an *early* settlement of all or part of the plan obligation. [*Emphasis* added.]

Another states:

> Settlements and curtailments are events that materially change the liabilities relating to a plan *and that are not covered by the normal actuarial assumptions*. [*Emphasis* added.]

7. Further under IAS 19, gains and losses are, in principle, recognised over an employee's service life. So, in principle, there should be no unrecognised gains and losses left on settlement at retirement. In fact, the methodology in IAS 19 for calculating the amounts to be deferred does not track gains and losses relating to individual employees, and using that 'broad brush' approach means that the unrecognised gains and losses calculated on a settlement at retirement may be large. Nonetheless, in principle, recognising an additional amount on settlement at retirement is unnecessary.

8. There is also a cost-benefit assessment that needs to be made. If all lump-sum payments are treated as settlements, there will be settlements every year. Is the recognition of any previously unrecognised gains and losses worth the cost of the calculation? Under US GAAP, such lump-sum payments are treated as settlements (see paragraph 9 below) but there is an arbitrary minimum level beyond which no adjustment for previously unrecognised gains and losses need be made. There is currently no such rule in IAS 19, and adding one does not seem desirable.

View B – a settlement

9. The words in paragraph 112 would seem to indicate that lump sum payments of the type in question are settlements. Further, it is clear that under SFAS 88 *Employers' Accounting for Settlements and Curtailments of Defined Benefit*

Pension Plans and for Termination Benefits such payments would be classified as settlements. SFAS 88 states:

> For purposes of this Statement, a settlement is defined as a transaction that (a) is an irrevocable action, (b) relieves the employer (or the plan) of primary responsibility for a pension benefit obligation, and (c) eliminates significant risks related to the obligation and the assets used to effect the settlement. Examples of transactions that constitute a settlement include (a) *making lump-sum cash payments to plan participants in exchange for their rights to receive specified pension benefits* and (b) purchasing nonparticipating annuity contracts to cover vested benefits. (Emphasis added)

10. The Basis for Conclusions for SFAS 88 also discusses situations in which an entity makes regular settlements as part of the normal running of the plan.

> The Exposure Draft would have proscribed recognition of a previously unrecognized net gain or loss if the cost of settlements was less than or equal to the amount of obligation arising from the service cost and interest cost components of net periodic pension cost during the current year. This occurs, for example, when a plan regularly purchases annuities each year for benefits accumulated in that year. The basis for that proposal was that recognition of a previously unrecognized net gain or loss should not be required if the portion of the obligation settled is insignificant and that an obligation settled in the year in which it was incurred would not ordinarily give rise to significant gains or losses. Several respondents suggested that the benefits covered by the settlement may not relate to the obligation arising in the current year as in the case of settlement of pension obligations for employees upon retirement. The Board acknowledges that possibility and concluded that recognition of a previously unrecognized net gain or loss should be permitted, but not required, if the costs of the settlements do not exceed the limit described above.

11. The definitions of a settlement are the substantially the same under IAS 19 and SFAS 88. It is therefore difficult to justify treating lump sum payments that form part of the normal running of the plan differently under the two standards.

12. Finally, there is no justification for continuing to defer recognition of gains and losses related to liabilities that no longer exist. Treating the payments in question as settlements prevents any deferral.

Staff recommendation

13. The staff is not aware of diversity in practice under IAS 19. Practice seems to be that payments made as part of the normal running of the plan are not treated as settlements. However, the wording of the definition in IAS 19 indicates that they are settlements. So as more jurisdictions adopt IFRSs, diversity from current practice may develop in the future. Further the staff argues that it is undesirable for there to be different interpretations under IAS 19 and US GAAP when the definition of settlement is substantially the same.

14. The staff therefore recommends that the IFRIC resolves the issue by stating that the definition of a settlement includes all payments that settle employee benefit obligations whether they are part of the plan or a separate event. Doing so makes IAS 19 consistent with the principle underlying SFAS 88, that all gains and losses relating to a liability should be recognised once the liability is settled. The staff thinks this is a good principle. The staff also does not think that the cost of calculating the amount to be recognised will be excessive. All that is required is a comparison of the defined benefit obligation before and after the settlement and a pro-rata calculation of the unrecognised gains and losses. The staff does not recommend introducing a minimum threshold similar to that in SFAS 88. The Board's approach to convergence is that broad convergence with a principle is desirable and sufficient. The introduction of an arbitrary bright line is unnecessary.

15. The staff does not think an Interpretation is necessary for the IFRIC to resolve the issue, given the wording of paragraph 112. The staff therefore recommends that the IFRIC reject the issue as follows.

> The IFRIC received a request to clarify whether some payments of benefits under a defined benefit plan are settlements as defined in IAS 19. The payments in question arise when a plan gives plan members the option to choose to receive a lump sum payment at retirement instead of ongoing payments.

The IFRIC notes that such payments meet the definition of settlements in paragraph 112 of IAS 19. The IFRIC therefore decided not to take the issue on to its agenda.