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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IFRIC meeting: **March 2008, London**

Project: **IAS 19 – *Employee Benefits* - Settlements (Agenda Paper 5)**

Introduction

1. At the January meeting, 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.

2. The IFRIC noted that in many jurisdictions a consistent treatment had developed under IAS 19 of not treating such payments as settlements. IFRIC members reported little diversity in practice. However, the IFRIC also noted that the wording in IAS 19 could be interpreted as including such payments in the definition of a settlement and that they would be treated as settlements under the US standard SFAS 88 *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*. The IFRIC instructed the staff to consult in order to understand the effect any proposed changes arising from a clarification of the definition of a settlement would have in practice.

3. This paper sets out the results of that consultation.

Issue

4. Whether 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 and the best estimate of the cash flows arising under each option. Then, when the lump sum is paid, different accounting applies depending on whether or not the payment is treated as a settlement.

5. 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. Under IAS 19, that actuarial gain or loss 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.

6. If the payment of a lump sum *is* treated as a settlement, the entity must first remeasure the obligation using current assumptions. Any gain or loss arising on *that* remeasurement is an actuarial gain or loss which is recognised as described above. A settlement gain or loss comprising the following is then recognised immediately in profit or loss:

   a. any change in the defined benefit obligation on settlement

   b. any change in the plan assets on settlement and

   c. a portion of any accumulated unrecognised gains and losses.

7. The staff notes that if the terms of the plan include the possibility of a lump sum payment, that possibility will be included in the actuarial assumptions. So, when the defined benefit obligation is remeasured immediately before the settlement, the actuarial assumptions will include the effect of the lump sum payment. Hence, the defined benefit obligation will have been remeasured so the amounts for a and b in paragraph 6 will exactly offset each other.[1] The only situation when this would not be the case is when the lump sum payment is not a possibility that has

[1] If the plan is unfunded, the amount in 6a will exactly equal the cash payment made by the entity.

been included in the actuarial assumptions, for example if it were an ad hoc lump sum payment not envisaged in the terms of the plan.

8. Consequently, for payments that are envisaged in the terms of the plan, the only settlement gain or loss that can arise is from the requirement to recognise a portion of any accumulated unrecognised actuarial gains and losses (c in paragraph 6). For entities that adopt an immediate recognition approach, lump sum payments envisaged in the terms of the plan will never give rise to a settlement gain or loss. For these entities, there would be no effect in practice of including such payments in the definition of settlements.

9. Of course, for entities that adopt a deferred recognition approach to actuarial gains and losses, the amounts under 6c could be substantial. If the lump sum payments in question were treated as settlements, such entities would have to remeasure the defined benefit obligation and calculate the amount in 6c at the date of each lump sum payment. Feedback from IFRIC members is that this would involve actuarial advice and the entity would have to assess whether it was necessary to perform several calculations (possibly very many) in a period or make one aggregate calculation on an averaged basis.

10. A further practical effect would be to introduce a GAAP difference between US GAAP and IFRS. Feedback from IFRIC members is that they very rarely see cash commutation treated as a settlement under SFAS 88 *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*. The payments clearly are settlements as defined under SFAS 88, but the standard allows a policy choice between treating the effect of these payments as a settlement and treating them as actuarial gains or losses when the service cost plus interest cost components of the net periodic pension cost for the year exceeds the cash paid out. In some jurisdictions, for example the UK, this is nearly always the case.[2] Forcing IFRS users to treat such payments as settlements would create a difference from common practice under US GAAP.

11. There are also issues relating to transition for entities adopting a deferred recognition approach to actuarial gains and losses. Retrospective application of a

[2] For example, in a typical year around 4% of the members of a UK pension plan might be expected to retire, and the assumption is usually that all will take the maximum cash (approximately 25% of their DBO). So, the amount of the DBO that is commuted is roughly 4% x 25% = 1%, but interest cost on its own is around 6% currently.

requirement to treat the payments as settlements would require an entity to remeasure the defined benefit obligation at every date in the past at which such a payment had been made, calculate what previously unrecognised gains and losses would have been recognised as part of the settlement gain or loss, and re-calculate the amortisation of the remaining unrecognised gains and losses. This would be an onerous task and, given the arbitrary nature of amortisation and the number of different ways of doing it, would provide no useful or comparable information.

Staff conclusion

12. Given these practical effects, the staff thinks that if the IFRIC were to require the employees' choice of lump sum payments to be treated as settlements, it should also:

    a. allow a minimum threshold, such as that in SFAS 88 and

    b. require prospective application of the new requirement.

13. The staff is reluctant to introduce an arbitrary minimum threshold into IAS 19. The standard has more than enough complicated rules already. The staff thinks that the existing consistent practice can described as regarding settlements as events that are not covered by the actuarial assumptions underlying the measurement of the defined benefit obligation. The staff therefore recommends that the IFRIC reject the issue on the grounds that there is no diversity from such an approach in practice. Suggested wording is given below.

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 an existing plan gives plan members the option to choose to receive a lump sum payment at retirement instead of ongoing payments.

The IFRIC noted that events that are covered by the actuarial assumptions underlying the measurement of the defined benefit obligation are not treated as settlements under IAS 19. The IFRIC did not add the issue to its agenda because there was little diversity in practice. Further, the IFRIC noted that, if the Board's current proposals in its post-employment benefits project were finalised, the payments in question would be accounted for in the same way, regardless of whether or not they are regarded as settlements.