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Employee Benefits

21 November 2018

Training agenda

- Overview of IAS 19
- Short-term benefits
- Post-employment benefits
- Other long-term benefits
- Termination benefits
- Business implications
- Interactive session

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Introduction

- IAS 19/IPSAS 25 specifies accounting for and disclosure of employee benefits by employers.
- IPSA 39, Employee Benefits, will replace IPSAS 25, Employee Benefits, on January 1, 2018, with earlier adoption encouraged.
- It is applied by an employer in accounting for all employee benefits, except those to which IFRS 2 Share-based Payment applies.
- IFRS 2 Share based payments specifies accounting and disclosure for employee benefits based on, or in the form of, the entity’s equity instruments.

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Main difference between IPSAS 39 and IPSAS 25

- Removal of an option that allowed an entity to defer the recognition of changes in the net defined benefit liability (the "corridor approach");

- Introduction of the net interest approach for defined benefit plans;

- Amendment of certain disclosure requirements for defined benefit plans and multi-employer plans;

- Simplification of the requirements for contributions from employees or third parties to a defined benefit plan when those contributions are applied to a simple contributory plan that is linked to service; and

- Removal of the requirements for Composite Social Security Programs.

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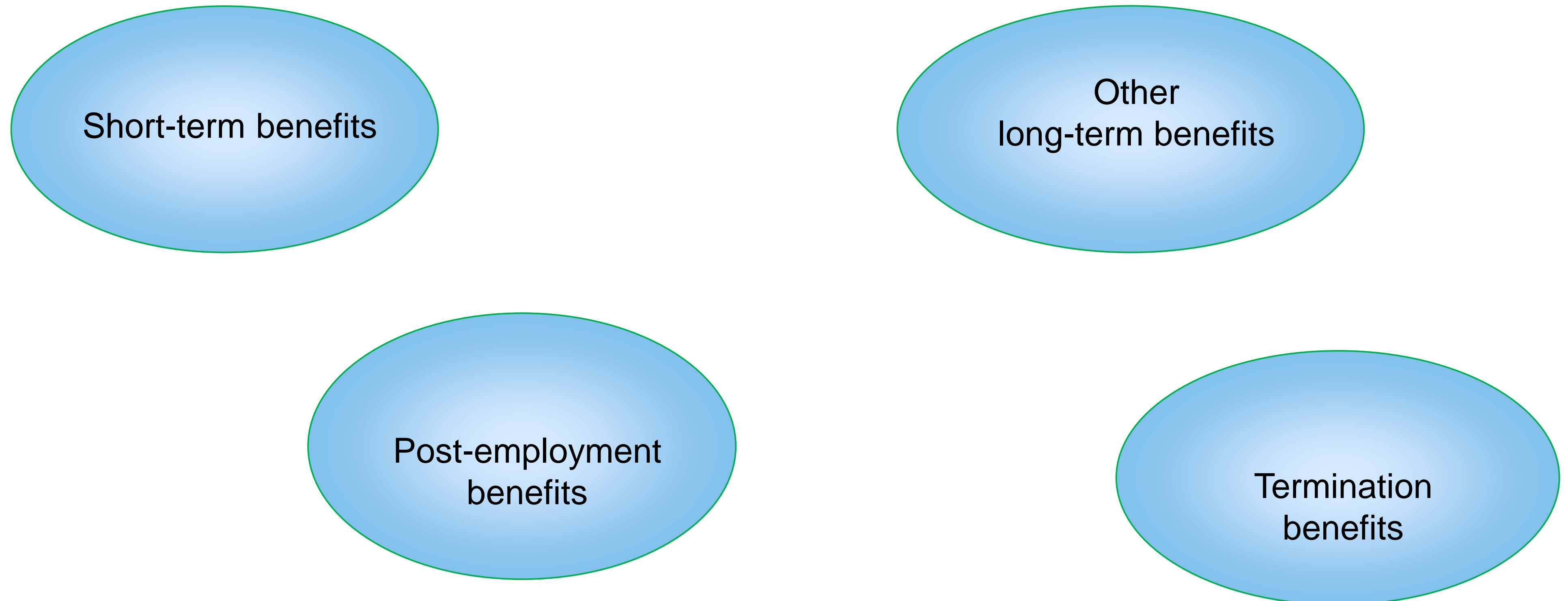
What are employee benefits?

Employee benefits are all forms of consideration paid for services of employees. IAS 19 separates employee benefits into 4 categories:



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What are short-term employee benefits?

- Short-term employee benefits are expected to be settled wholly before 12 months after the period in which the employee rendered the related service.

- Recognised as an expense as the employee provides the related service.

- Obligations measured at undiscounted amounts.

- Examples include:
  - ✓ Wages, salaries and social insurance
  - ✓ Short-term compensated absences
  - ✓ Profit sharing/bonuses (payable within 12 months of year end)
  - ✓ Non-monetary benefits

- Accounted for on an **accruals basis**

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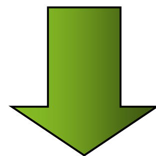
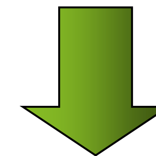
What are post-employee benefits?

Post-employment benefits are payable after the completion of employment.
There are two types:

1. **Defined contribution plan**, entity pays fixed contributions to a separate entity (a fund) and has no obligation to pay further contributions if the fund cannot pay employee benefits.
2. All other post-employment plans are **defined benefit plans**.

Defined contribution schemes	Defined benefit schemes
The entity pays agreed contributions into a plan and has no further liability	Any other type of scheme. Typically a pension is guaranteed based on final salary





Defined contribution schemes	Defined benefit schemes
Accounted for on an accruals basis	Accounted for using the projected unit credit method

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Defined contribution >>>

- Employees (not the employer) are exposed to risks
- Employer recognises contributions payable as an expense as the employee provides services in exchange for the contributions.
- Obligations measure at undiscounted amounts.

Defined benefits >>>

- Recognise the defined benefit liability as follows:
  - use the projected unit credit method based on actuarial assumptions to measured the obligation at its present value; less
  - the fair value of plan assets (if any).
- Recognise all changes in the defined benefit liability (asset) when they occur:
  - Service costs and net interest in profit and loss
  - Remeasurements in OCI.

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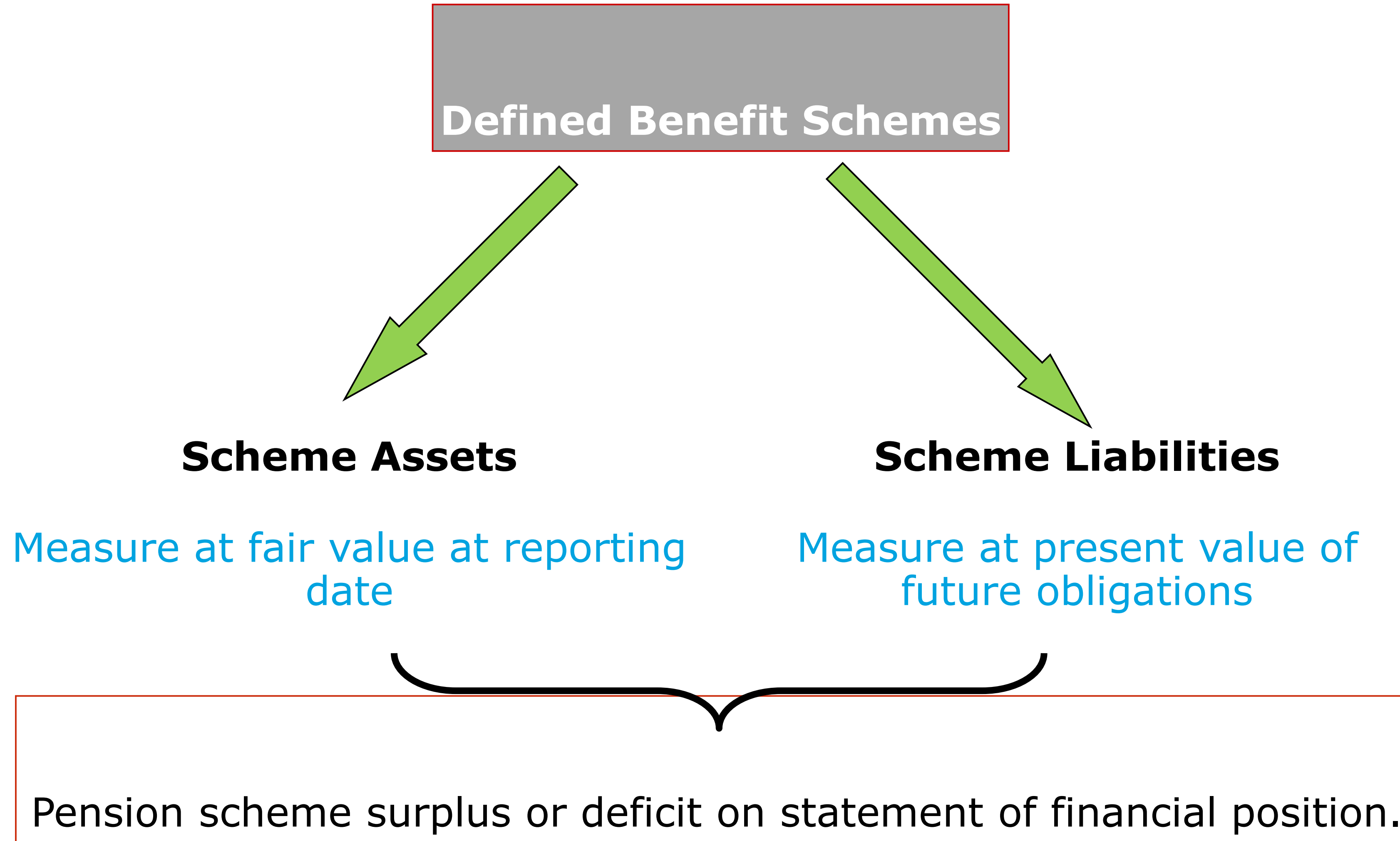
Defined benefits



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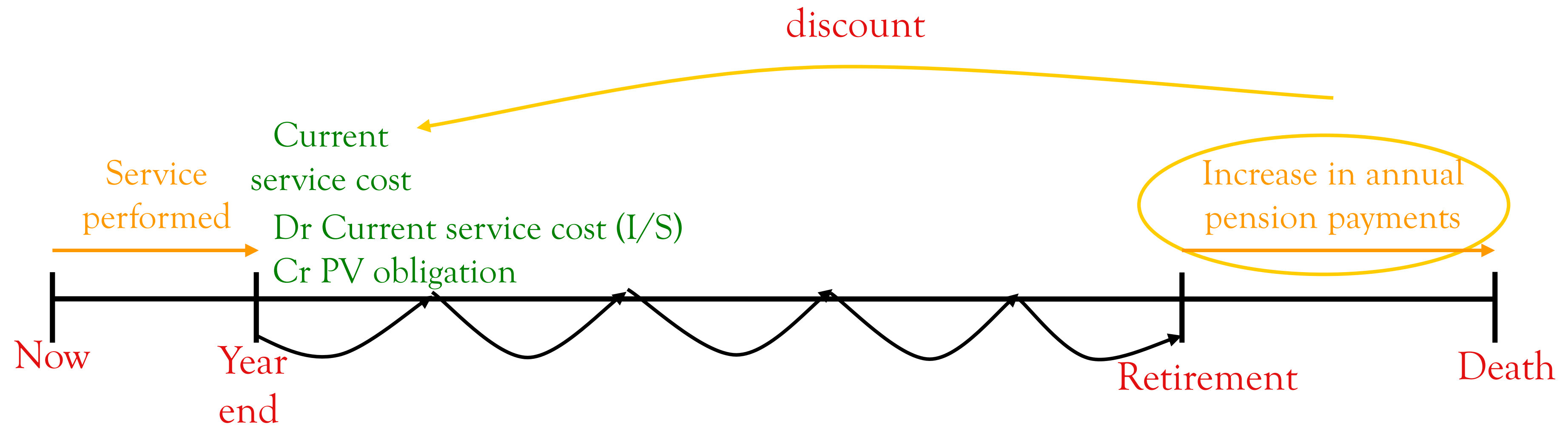
Present value of pension obligation . . . .



compound

Dr Interest cost (I/S)
Cr PV obligation

Discount/compound using market yields on high quality corporate bonds

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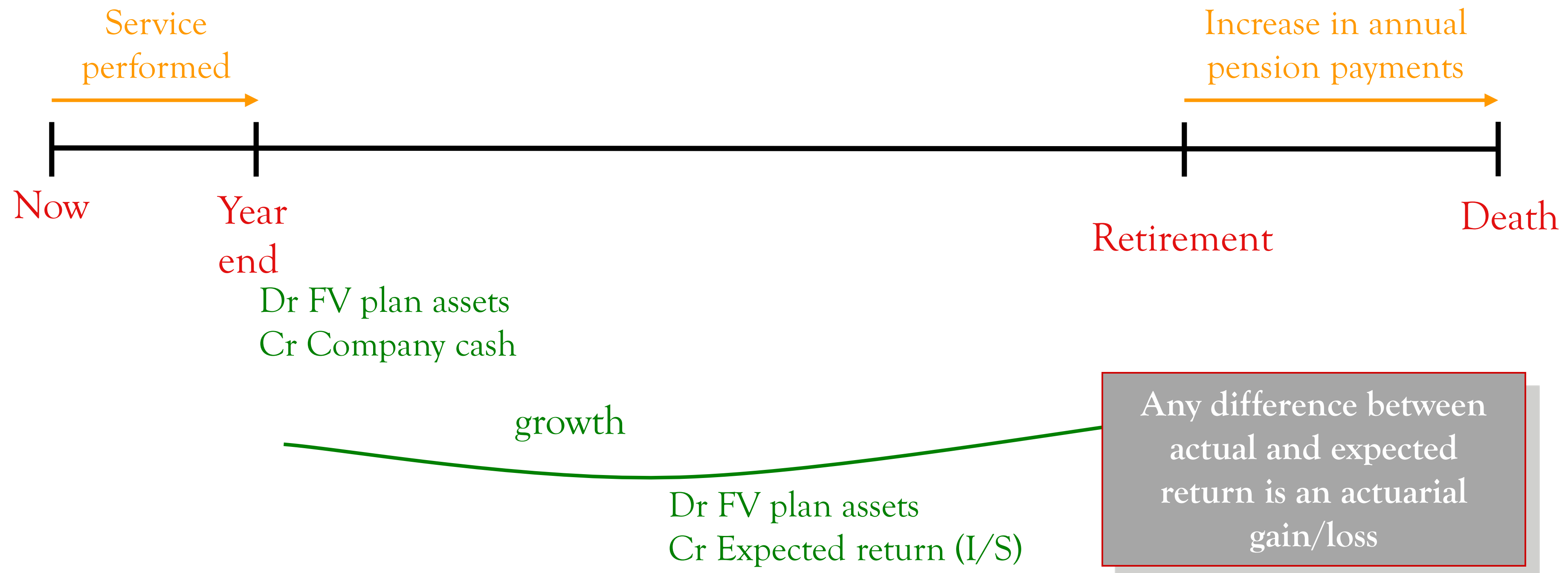
Fair value of planned assets . . . .

Contributions are paid in as advised by an actuary



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Defined benefits. . . . in summary

- Under a defined benefit scheme the (net) surplus or deficit on the pension fund is shown on the entity's balance sheet. If there is an excess of liabilities over assets a deficit is recognised, vice versa a surplus.

- The carrying value of the surplus or deficit is the fair value of the schemes' assets, less the present value of the schemes' liabilities, plus or minus the actuarial gains/losses and past service costs not yet recognised.

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Projected Unit Credit Method . . . . example

- A new employee has current salary of Ksh. 50,000, expected to increase at a rate of 4% per annum over the next 5 years. The employee is a member of the firm's defined benefit scheme, and is entitled to a lump sum on retirement (expected to be in 5 years) of 2% of final salary for each year of service. A discount rate of 5% is applied.

- Calculate the obligation at the end of each year

Salary at end of year 5

Ksh. 50,000 x 1.04^5=Ksh. 60,833

Benefit attributable to each year

Ksh. 60,833 x 2%=Ksh.1,217

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Projected Unit Credit Method . . . . solution

Year	1	2	3	4	5
Benefit attributed to:					
- Prior years	0	1,217	2,434	3,651	4,868
- Current year	1,217	1,217	1,217	1,217	1,217
Current and prior years	**1,217**	**2,434**	**3,651**	**4,868**	**6,085**

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Projected Unit Credit Method . . . . solution

Year 3 example

Present value of obligation at end of year 3	$\frac{\text{Ksh3,651}}{1.05^3}$	=	Ksh.3,154
Present value of obligation at end of year 2	$\frac{\text{Ksh.2,434}}{1.05^2}$	=	Ksh.2,208

Movement	Ksh.946
Interest cost	Ksh.110
Service cost (balance)	Ksh.836

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Recognition in the statement of profit or loss

- Current service cost
- Net Interest on the Net Defined Benefit Liability (Asset)
- Past service costs

Other comprehensive income

- Actuarial gains and losses (to the extent they are recognised)

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Current service cost

- The **current service cost** is defined as ‘the increase in the present value of the defined benefit obligation resulting from employee service in the current period’.
- It is the present value of the increase in cost due to the employee having worked one extra year.
- This cost is determined independently of the funding of the plan, and should be the same irrespective of whether the plan is in deficit or surplus. It is not necessarily a stable percentage of pensionable pay year on year. It will vary if the discount changes or if the average age of employees changes.

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Past service cost

- **Past service costs** are 'the increase in present value of the defined benefit obligation for employee service in prior periods, resulting in the current period from the introduction of, or changes to, post-employment benefits or other long term employee benefits'.
- An example would be if the rules changed so that pensions payment increased by a minimum increment each year so, instead of an employee's pension being fixed on retirement, it increases over the rest of his/her life.
- When there are changes to the level of benefits already earned, the present value of the increase or reduction in benefits should be charged to the income statement over the period during which the increases vest.

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Net Interest on the Net Defined Benefit Liability (Asset)

- The interest cost recognized in the statement of profit or loss each year is the unwinding of the discount on the scheme liabilities (the previous closing obligation multiplied by the interest rate).

- The expected return on plan assets reflects how a scheme is funded. The statement of profit or loss is credited each year with the expected long term rate of return on the assets based on their market values at the beginning of the year

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Actuarial gains and losses

Actuarial gains and losses comprise:

- Experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred), and
- The effects of changes in actuarial assumptions.
- For example, an actuarial gain or loss would be the difference between the expected return on plan assets and the actual return on those assets. Or the effect of changes in life expectancy expectations, or rate of salary increases.

IAS 19 permits two methods of recognition of actuarial gains and losses.

i. They may, as an accounting policy, applying to all schemes, be **recognised immediately in equity** but only if the entity presents a Statement of Recognised Income and Expense, which is permitted by IAS 1, 'Presentation of Financial Statements'.

ii. Alternatively, IAS 19 permits **deferral of actuarial gains** as an accounting policy by **the corridor method**. Actuarial gains and losses are not usually recognised immediately, though they may be if the company has a policy of doing so.

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Disclosures for defined benefit schemes

- Accounting policy
- Description of plan
- Reconciliation of assets and liabilities in the balance sheet
- Fair value of plan assets
- Reconciliation of movement in liabilities
- Breakdown of income statement expense
- Actual return on plan assets
- Actuarial assumptions

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Other long-term benefits

- Other long-term benefits are all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits.

- Recognition and measurement is the **same as that for post-employment benefits: defined benefit plans**.

- Examples include: Long-term compensated absences; Long-service benefits; Profit sharing/bonuses (payable 12 months or more after year end); Deferred compensation; and Post-employment healthcare

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Terminal benefits

- Termination benefits **arise only on termination**, rather than during employment.
  - Principle—the event that gives rise to an obligation is the termination of employment rather than employee service
- Recognise expense and a liability at the earlier of:
  - when the entity can no longer withdraw the offer of those benefits
  - when the entity recognises the related restructuring provision in accordance with IAS 37.
- Termination benefits at times occur as a result of an offer made in order to encourage voluntary redundancy.

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Business Implications

- The main feature of IAS 19 is the requirement to recognise, as a liability, the obligation to provide post-employment or long-term employee benefits under a defined benefit plan, as a result of service already provided by employees to the entity.

- Significant judgement and estimates to measure the liability for a defined benefit post-employment plan, for example, mortality, employee turnover, age at and date of retirement, rates of return on plan assets, future salary and benefit levels, future medical costs and the discount rate.

- Consequently, extensive disclosures required to:
  - explain characteristics of the plan and associated risks
  - identify and explain related amounts in financial statements
  - possible affects on the amount, timing and uncertainty of future cash flows

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Example

Copco operates a defined benefit pension plan for its employees. The company elects to use the corridor method under IAS 19.

Present value of defined benefit obligation

	Ksh'm	
b/d	**110**	
Interest cost (10% x 110)	11	Dr Income statement
Current service cost		
Benefits paid		
Actuarial gain (balancing figure)	____	
c/d	____	

Notes

(1) The present value of the future benefit obligations on 1 January 2008 were Ksh110 million.

(2) The yield on high quality corporate bonds in the year to 31 December 2008 was 10%.

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Example

Present value of defined benefit obligation

	Ksh'm	
b/d	**110**	
Interest cost **(10% x 110)**	**11**	Dr Income statement
Current service cost	13	Dr Income statement
Benefits paid	(10)	Cr Plan assets
Actuarial gain (balancing figure)	___	
c/d	___	

Notes

(3) The present cost of pensions earned this year was Ksh13m.

(4) Pensions paid to former employees during the year amounted to Ksh10m.

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Example

Present value of defined benefit obligation

	Ksh'm	
b/d	110	
Interest cost (10% x 110)	11	Dr Income statement
Current service cost	13	Dr Income statement
Benefits paid	(10)	Cr Plan assets
Actuarial gain (balancing figure)	(8)	→ Unrecognised actuarial gains/losses
c/d	116	

Notes

(6) Extracts from the most recent actuary's report show the following:

	31.12.2008
Present value of pension plan obligation	Ksh116m

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Example

Fair value of plan assets

	Ksh'm	
b/d	150	
Expected return (12% x 150)	18	Cr Income statement
Contributions received	7	Cr Company cash
Benefits paid	(10)	Dr PV obligation (done)
Actuarial loss (balancing figure)	___	
c/d	___	

Notes

(7) The fair value of plan assets on 1 January 2008 was Ksh150 million.

(8) The expected return on investments is 12%.

(9) The pension plan received contributions of Ksh7m and paid pensions to former employees of Ksh10m.

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Example

Fair value of plan assets

	Ksh'm	
b/d	**150**	
Expected return **(12% x 150)**	**18**	Cr Income statement
Contributions received	**7**	Cr Company cash
Benefits paid	**(10)**	Dr PV obligation (done)
Actuarial loss (balancing figure)	(25)	→ Unrecognised actuarial gains/losses
c/d	**140**	

Notes

(10) Extracts from the most recent actuary's report show the following:

	31.12.2008
Market value of plan assets	Ksh140m

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Example

Unrecognised/recognised actuarial gains and losses

	Ksh'm
Unrecognised gains b/d	63
Gains b/d recognised in the income statement	
Actuarial gain on obligation *during year*	
Actuarial loss on assets *during year*	___
Unrecognised gains c/d	___

Notes

(11) In the financial statements for the year ended 31 December 2007, there was an actuarial gain of Ksh63 million although this had not been recognised.

(12) The average remaining working life of plan members at 1 January 2008 is 7 years.

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Example

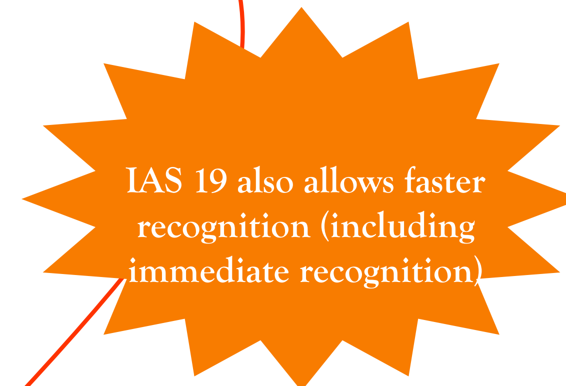
Unrecognised/recognised actuarial gains and losses

	£'m	
Unrecognised gains b/d	63	
Gains b/d recognised in the income statement (Working)	(7)	Cr: statement of P/L
Actuarial gain on obligation *during year* (from before)	8	
Actuarial loss on assets *during year* (from before)	(25)	
Unrecognised gains c/d	39	

Working – The 10% Corridor

Corridor limits, greater of:	£'m
10% obligation b/d (10% x £110m)	11
10% plan assets b/d (10% x £150m)	15
Therefore, corridor limit	15

Gains b/d recognised in the statement of P/L:	
(£63m – £15m)/ 7 years	7



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Example

STATEMENT OF PROFIT OR LOSS

Expense recognised in profit or loss	Ksh'm
Current service cost	13
Interest cost	11
Expected return on plan assets	(18)
Net actuarial (gains)/losses recognised	(7)
	(1)

IAS 19 is flexible about exactly where in the income statement each of the above is recognised, but the line item in which each is recorded must be disclosed.

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Example

STATEMENT OF FINANCIAL POSITION

	Ksh'm
Fair value of plan assets	140
Present value of defined benefit obligation	(116)
	24
Unrecognised actuarial gains	(39)
Net pension liability	**(15)**

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Example

MOVEMENT IN NET PENSION LIABILITY

	Ksh'm
Opening net liability (110 – 150 + 63)	**23**
Expense recognised in the income statement	(1)
Contributions paid	(7)
Closing net liability	**15**

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