

IAS 19, employee benefits

relevant to Professional Scheme Paper 3.6 (INT)
and new ACCA Qualification Paper P2 (INT)

pension accounting

■ This article outlines the principles of accounting for employee benefits, as defined by IAS 19, *Employee Benefits*. Unlike the UK standard, FRS 17, which sets out the accounting treatment for retirement benefits – such as pensions and medical care during retirement – IAS 19 deals with other employee benefits including:

- short-term employee benefits, such as wages and salaries
- post-employment benefits, such as pensions
- termination benefits, such as severance pay
- other long-term employee benefits, including long service leave.

This article also deals with post-employment benefits and, in particular, defined contribution and defined benefit plans. An understanding of the definitions of certain terms is critical. A major problem for students is often confusion over what the various terms actually mean. The accounting entries are relatively simple but students find it difficult to relate to the nature of the transaction being carried out. First, it is important to understand the nature of the two types of pension scheme.

DEFINED CONTRIBUTION PLAN

In a defined contribution pension plan, a company pays a fixed pension contribution into a separate entity (fund) and has no legal or constructive obligation to pay further contributions if the fund does not have sufficient assets to pay employee benefits relating to employee service in the current and prior periods. A company should recognise contributions to a defined contribution plan where an employee has rendered service in exchange for those contributions. All other post-employment benefit plans are classified as defined benefit plans.

The accounting for a defined contribution scheme is fairly simple because the employer's

obligation for each period is determined by the amount that has to be contributed to the scheme for that period.

DEFINED BENEFIT PLAN

Under a defined benefit pension plan, the benefits payable to the employee are not based solely on the amount of the contributions (as in the defined contribution scheme), but are determined by the terms of the defined benefit plan. This means that the risk remains with the employer and the employer's obligation is to provide the agreed amount of benefit to current and former employees.

In accounting for a defined benefit plan, a company should regularly determine the present value of any defined benefit obligation and the fair value of any plan assets. This makes sense as a company will need to know its net liability for employee benefits.

KEY FEATURES

It is important to understand certain key terms:

- **Current service cost** is the increase in the present value of the defined benefit obligation which occurs as a result of employee service in the current period. In simple terms, this is the amount of pension entitlement that employees have earned in the accounting period. Therefore, it will increase the pension liability in the balance sheet and be expensed in the income statement.
- **Past service cost** is the increased present value of a defined benefit obligation for an employee's service in previous periods, which has arisen because of the introduction of changes to the benefits payable to employees. In other words, this represents an increase or decrease in the employer's liability because of a change in the terms of the pension scheme. The pension liability in the balance sheet will increase or decrease, and the income statement will be affected accordingly.

- **Interest cost** is the increase in the period in the present value of the defined benefit obligation which arises because the benefits payable are one year closer to the settlement of the scheme. It represents the unwinding of the discount on the plan's liabilities. It is calculated by multiplying the discount rate at the beginning of the period by the present value of the defined benefit obligation throughout the period. This, in theory, means that a form of averaging should take place to calculate the 'average' present value of the obligation in the period. For exam purposes, the approach taken by the example in IAS 19 will be adopted. That is, the interest cost will be calculated on the basis of the opening obligation. The interest cost will increase the obligation and will be charged to the income statement.

- **Expected return on plan assets** is based on the market's expectations of the return expected from the pension scheme's assets. It is calculated using the expected long-term rate of return on the plan assets at the beginning of the period. The amount so calculated will be added to the scheme's assets and will be credited to the income statement.

DEALING WITH DEFINED BENEFIT PLANS IN THE FINANCIAL STATEMENTS

The present value of a defined benefit obligation, and the fair value of the plan assets are determined at the end of each accounting period. Additionally, the scheme will receive contributions that will increase the plan assets, and will pay out pension benefits which will, in turn, reduce the obligation and the plan assets. Having defined key terms and events, it is now possible to show how these elements are dealt with in financial statements, as shown in **Table 1** on page 61. Random amounts

have been used for this example, and at this stage we are not dealing with the recognition of actuarial gains and losses arising out of the scheme. There are no actuarial gains and losses arising at 01/01/X1.

The total amount charged in the income statement will be \$90m. The gain on the plan assets and the loss on the obligation are just the balancing figures and amount to a net loss of \$30m (\$140m - \$170m) and this has not been recognised anywhere in the financial statements.

As a result, the liability in the balance sheet will be \$1,070m (\$2,300m - \$1,200m - \$30m). Another way of showing this amount is:

Opening net liability (1,000 - 2,000)	1,000
Net amount charged in income statement	90
Contributions	<u>(20)</u>
	<u>1,070</u>

As can be seen, the liability is either calculated by taking the opening balances and adjusting for the charge in the income statement and contributions to the scheme, or by taking the closing balances and deducting the unrecognised loss. Either way will obviously produce the same result.

SUMMARY

The amount recognised in the balance sheet

will be as follows:
the present value of the defined benefit obligation
minus
the fair value of the plan assets at the balance sheet date
plus
any actuarial gains
less
losses not yet recognised
minus
any past service cost not yet recognised.

If the result of the above is a positive amount then a liability occurs and it is recorded in full

in the balance sheet. Any negative amount is an asset, which is subject to a recoverability test. The pension expense is the net of the following items:

- current service cost
- interest cost
- the expected return of any plan assets
- past service cost (to the extent that the standard requires the company to recognise it)
- the effect of any curtailments or settlements and actuarial gains and losses to the extent recognised (more on this later).

MEASURING THE DEFINED BENEFIT OBLIGATION

IAS 19 states that the projected unit credit method should be used to determine the present value of the defined benefit obligation, the related current service cost, and past service cost.

This method looks at each period of service, and so creates an additional increment of benefit entitlement. The method then measures each unit of benefit entitlement separately to build up the final obligation. The whole of the post-employment benefit obligation is discounted.

The use of this method involves a number of actuarial assumptions, based on the company's best estimate of the variables that will determine the final cost of the post-employment benefits. These variables include wider issues such as mortality rates or changes in the retirement age, and financial assumptions such as discount rates and benefit levels. Note that plan assets are measured at fair value. Fair value is normally market value, where available, or estimated value where it is not.

GAINS AND LOSSES

A company should recognise its actuarial gains and losses under one of three methods:

- 1 The 'corridor' approach: actuarial net gains and losses are recognised as income or expenditure if cumulative, unrecognised, actuarial gains and losses at the end of the previous reporting period (ie at the beginning of the current financial year) exceed the greater of:
 - 10% of the present value of the defined benefit obligation at the beginning of the year, and
 - 10% of the fair value of the plan assets at the same date.

- 10% of the present value of the defined benefit obligation at the beginning of the year, and
- 10% of the fair value of the plan assets at the same date.

These limits should be calculated and applied separately for each defined plan. The excess determined by the above method is then divided by the expected average remaining working lives of the employees in the plan in order to give the income or expense to be recorded in the income statement.

- 2 Recognised in full as they occur in the statement of recognised income and expense.
- 3 Any other systematic method that results in a faster recognition of actuarial gains and losses in the income statement, provided that the same basis is applied to both gains and losses and that the basis is applied consistently from period to period.

EXAMPLE 1

A company has a defined benefit pension plan. At 1 January 20X1 the following values relate to the plan:

- The fair value of the plan assets is \$30m.
- The present value of the defined benefit obligation is \$25m.
- There are cumulative unrecognised actuarial gains of \$4m.
- The average remaining working lives of employees is 10 years.

At the end of the period, at 31 December 20X1, the following values relate to the pension scheme:

- The fair value of the plan assets has risen to \$35m.
- The present value of the defined benefit obligation has risen to \$28m.
- The actuarial gain is \$5m.
- The average remaining working lives of employees is 10 years.

Required

Show the ways in which actuarial gain could be treated for the period ending 31 December 20X1 (the asset ceiling test is ignored in this example).

Answer

There are three possible treatments:

- 1 The company could recognise the portion of the net actuarial gain or loss in excess of 10% of the greater of the defined benefit obligation or the fair value of the plan assets at the beginning of the year.

Unrecognised actuarial gain at the beginning of the year was \$4m. The limit of the corridor is 10% of \$30m (ie \$3m) as the fair value of the assets is greater than the value of the obligation. The difference is \$1m which, divided by 10 years, is \$0.1m to be recognised in profit or loss. The accounting for the corridor approach takes no account of actuarial gains and losses arising in the year – instead it considers the state of the plan at the previous year end.
- 2 The actuarial gains and losses can be recognised in full in the statement of recognised income and expense. Accordingly, the \$5m gain will be recognised in the statement. This gain cannot be recycled through the income statement and should be added to retained earnings.
- 3 Any other systematic method that results in a faster recognition of actuarial gains and losses in the income statement can be used. So, all the actuarial gain of \$5m can be recognised in the income statement, but this is extremely rare in practice.

RESTRICTIONS ON THE AMOUNT RECOGNISED AS A DEFINED BENEFIT ASSET

IAS 19 restricts the amount that can be shown as a defined benefit asset.

The asset may not exceed the aggregate of:

- any cumulative, unrecognised net actuarial losses and past service cost, and
- the present value of any refunds from the plan or reductions in future contributions.

EXAMPLE 2

- The fair value of the plan assets is \$130m
- The present value of the defined benefit obligation is \$105m
- There are cumulative unrecognised actuarial losses of \$4m

A useful exercise for students is to work through Question 2 from the December 2005 Paper 3.6 exam paper.

- Present value of refunds from the plan, and reductions in future contributions, is \$23m.

Solution

The asset in the balance sheet will be:

	\$m
The fair value of the plan assets	130
The present value of the defined benefit obligation	(105)
Cumulative unrecognised actuarial losses	<u>4</u>
	<u>29</u>

The cumulative unrecognised actuarial losses, plus the present value of refunds from the plan and reductions in future contributions, amounts to \$27m (\$4m + \$23m). Therefore, the asset is restricted to this figure. The amount written off the asset would go to the income statement.

SETTLEMENTS AND CURTAILMENTS

A curtailment occurs where a company either reduces the number of employees covered by the plan or amends the terms of a defined benefit plan. An amendment would normally be such that a material element of future service by current employees will no longer qualify for benefits or will qualify for a reduction in benefits.

Curtailments can have a material impact on the entity's financial statements and are often linked to restructuring or reorganisation. A company settles its obligations where it enters into a transaction that eliminates future legal and constructive obligation for part or all of the benefits provided under a defined benefit plan. Settlements are usually lump sum cash payments made to, or on behalf of, the plan participants in exchange for the extinguishment of the right to receive future benefits.

Where a curtailment relates only to some employees covered by the plan, the obligation is only partly settled. Any gain or loss calculated should include a proportionate share of the previously unrecognised past service cost and actuarial gains and losses. Before determining the effect of a curtailment, the company has to remeasure the obligation and plan assets using current actuarial assumptions.

EXAMPLE 3

- A company closes down its subsidiary, and the employees of that subsidiary no longer earn further pension benefits.
- The company has a defined benefit obligation with a net present value of \$60m. The plan assets have a fair value of \$48m.
- There are net cumulative and actuarial unrecognised gains of \$4m.
- The curtailment reduces the net present value of the obligation by \$6m.

Requirement

Calculate the curtailment gain and the net liability recognised in the balance sheet after the curtailment.

Answer

Please see **Table 2** below. It is assumed that 10% (6 ÷ 60) of the previously unrecognised actuarial gains relate to the obligation eliminated.

CONCLUSION

This article sets out the basic elements of pension accounting. There are several complexities which have not been covered in this article. It is a topic that appears regularly in examination questions and students should be capable of producing both written and computational answers on the subject. ■

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TABLE 1: FINANCIAL STATEMENT SHOWING DEFINED BENEFIT PLANS

	Scheme assets \$m	Scheme liabilities \$m	Income statement \$m
Opening balance 01/01/X1	1,000	2,000	
Interest cost (5% of 2,000)		100	(100)
Expected return on plan assets (7% of 1,000)	70		70
Current service cost		40	(40)
Past service cost		20	(20)
Benefits paid	(30)	(30)	
Contributions	20		
Gain on plan assets (difference)	140		
Loss on obligation (difference)		170	
Net amount charged			<u>(90)</u>
Closing balance 31/12/X1	<u>1,200</u>	<u>2,300</u>	

TABLE 2: BALANCE SHEET AFTER CURTAILMENT

	Obligation before curtailment \$m	Gain on curtailment \$m	Obligation after curtailment \$m
Net present value of obligation	60	(6)	54
Fair value of plan assets	<u>(48)</u>	-	<u>(48)</u>
	12	(6)	6
Unrecognised actuarial gains	4	(0.4)	3.6
Net liability in balance sheet	<u>16</u>	<u>(6.4)</u>	<u>9.6</u>