Accounting standard study group

CIMA Sri Lanka Division

Study of LKAS 19: Employee benefits

A. Scope

LKAS 19 deals with all employee benefits, except those to which SLFRS 2 applies (share based payments).

- benefits provided under formal plans and informal agreements
- benefits under legislative requirements, or through industry arrangements
- benefits as a result of informal practices that give rise to constructive obligation.

Employee benefits include:

- short term employment benefits – wages, salaries, paid annual/sick leave etc
- post employment benefits – pensions, other retirement benefits, post employment medical care
- other long term employee benefits - jubilee or other long-service benefits, deferred compensation;
- termination benefits.

B. Objectives of the study

The objective of this standard is to prescribe the accounting and disclosure for employee benefits.
Executive summary

LKAS 19 gives detailed description of the accounting treatment and presentation of employee benefits. The management of an entity needs to exert due care in the consistent application of this standard, and a clear understanding of the standard is imperative to enable a relatively seamless transition. On a global perspective IAS 19 has been subjected to some changes (effective from 2013) with an objective of enhancing comparability between IFRS reporters.

This document is presented as an initial overview of the standard and does not aim to answer all of the questions that may arise in terms of complexities.

Key concepts/definitions

Short term employee benefits

Short-term employee benefits are those benefits (other than termination benefits) due to be settled within 12 months after the end of the period in which the services have been rendered. Such benefits are accounted for using normal accrual accounting. No actuarial assumptions are used to measure the obligation/cost and there is no computation of actuarial gain/loss. Further, no discounting techniques are used.

Post employment benefits

These are employee benefits (other than termination benefits) which are payable after the completion of employment. Post-employment benefit plans are formal or informal arrangements under which an entity provides post-employment benefits for one or more employees.

<table>
<thead>
<tr>
<th>Defined contribution plans</th>
<th>Defined benefit plans</th>
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</thead>
<tbody>
<tr>
<td>Fixed contribution by the employer. No legal or constructive obligation to pay further contributions.</td>
<td>It is linked to the defined benefit as opposed to a fixed contribution.</td>
</tr>
<tr>
<td>Actuarial risk and investment risk falls on the employee</td>
<td>Investment risk and actuarial risk lies with the employer. As the obligation is to provide a benefit</td>
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<tr>
<td>No liability is shown, unless contribution is not paid</td>
<td>Liability is shown net of plan assets</td>
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Constructive obligations

Post employment benefit plans include not only formal arrangements but also informal arrangements that give rise to constructive obligations. Constructive obligations arise when an entity has no realistic alternative but to pay the employee benefits. A constructive obligation may arise from informal past practices or communication with employees.

Recognition and measurement for defined contribution plans

Contributions accounted on accrual basis, for example, a liability and an expense is created.

Recognition and measurement for defined benefit plans

- using actuarial techniques: determine benefits attributable to current and prior periods
- establish present value of defined benefit obligation and current service cost: projected unit credit method is used
- establish fair value of plan assets
- determine actuarial gains/losses and the amounts to be recognised: actuarial assumptions are an entity's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits. They are made up of demographic and financial assumptions
- determining the past service cost: when plan the plan was introduced or changed
- where a plan has been curtailed or settled, determining the resulting gain or loss.

Accounting for defined benefit plans

The amount recognised as a defined benefit liability in the statement of financial position shall be the net of the following:

- the present value of the defined benefit obligation at the end of the reporting period
- plus any actuarial gains (less any actuarial losses) not recognised
- minus any past service cost not yet recognised
- minus the fair value at the end of the reporting period of plan assets (if any) out of which the obligations are to be settled directly.
The total cost comprises the following: profit and loss computation

- current service cost, including the current period impact of the asset ceiling, when actuarial gains and losses are recognised through profit or loss
- interest cost
- expected return on plan assets, including on any reimbursement rights
- actuarial gains and losses: An entity can decide between an accounting policy of recognising actuarial gains and losses in profit or loss, or immediate recognition in other comprehensive income (OCI). If an entity decides on the former, then an entity may choose to recognise cumulative gains and losses using the ‘corridor method’ or choose a method that resulting in faster recognition.

**Corridor method**

Actuarial gains and losses are recognised when the cumulative (unrecognised) amount thereof at the beginning of the period exceeds a ‘corridor’. The corridor is 10 percent of the greater of the present value of the obligation and the fair value of the assets. The corridor is calculated separately for each plan.

The excess of the corridor as determined above is amortised on a straight-line basis over the expected average remaining working lives of the employees participating in the plan. This represents the minimum amount of cumulative actuarial gains and losses that should be recognised.

An entity is permitted to recognise actuarial gains and losses in profit or loss in any systematic method that results in faster recognition than using the corridor method. Therefore, an entity should choose an accounting policy to be applied consistently.

An entity may choose an accounting policy of recognising actuarial gains and losses in the periods in which they occur outside profit or loss (i.e. in other comprehensive income). If this accounting policy is selected, then actuarial gains and losses are presented in the statement of comprehensive income.

If the terms of a plan are changed from covering a select group of employees to covering all employees, then the change is treated as a plan amendment that may give rise to a past service cost, or as a new plan, rather than as an actuarial loss.

- Past service costs: Past service cost is the change in the present value of the obligation, in respect of prior periods' service, due to changes in benefit entitlement.

Past service cost normally results in an increase in the liability (i.e. benefits are improved), but if benefits are reduced (e.g. if an entity retroactively reduces its accrual rate of pensionable earnings), then those changes result in a reduction of the liability (negative past service cost).

- The effect of any curtailments or settlements: A settlement is an early settlement of all or part of the plan obligation

A curtailment occurs when the entity is demonstrably committed to reduce significantly the number of employees in the plan or amends the terms of the plan so that the benefits for future services are reduced or eliminated. A change in future benefits is treated as a curtailment, rather than an actuarial gain or loss, if the effect of the re-measurement is significant.

**Other consideration**

Asset ceiling: If the statement of financial position amount turns out to be an asset, then the amount recognised is limited to the present value of available contribution reductions or refunds plus unrecognised actuarial losses and unrecognised past service costs. Further requirements ensure that a gain (loss) is not recognised solely as a result of an actuarial loss (gain) or a past service cost in the current period.

**Other long-term employee benefits**

An employee benefit, other than post-employment benefits or termination benefits, that are due to be settled more than 12 months after the end of the period in which the employee services were rendered, is classified as other long-term benefits.

For example, long-term compensated absences such as long-service or sabbatical leave, profit-sharing and bonuses payable twelve months or more after the end of the period in which the employees render the related service, deferred compensation paid twelve months or more after the end to the period in which it is earned.
The accounting for other long-term employee benefits is similar to post-employment benefits, except that all actuarial gains and losses and past service costs are recognised immediately in profit or loss. Neither the corridor method nor the immediate recognition of actuarial gains and losses in other comprehensive income may be applied for other long-term benefits.

Further, the employer’s statement of financial position includes a liability for the present value of the obligation at the end of the reporting period less the fair value of any plan assets (if any) at the end of the reporting period, out of which obligations are to be settled directly.

Termination benefits

The event which gives rise to an obligation is the termination rather than employee service. An entity shall recognise termination benefits when, and only when, the entity is demonstrably committed to either terminate an employee before the date of retirement or an employee's decision to accept an offer of voluntary redundancy.

Expenses and liabilities for termination benefits are recognised immediately when the employer has an obligation to make the payment.

Presentation and disclosure

This standard does not specify whether an entity should distinguish current and non-current portions of assets and liabilities arising from post-employment benefits. Assets and liabilities related to defined benefit plans generally are presented as non-current, but if the distinction between the current and non-current portions is clear, then split presentation is permitted.

Assets and liabilities related to defined contribution plans normally are current and are presented as such.

Assets that meet the definition of plan assets and the related liabilities are presented on a net basis in the statement of financial position. All other assets and obligations are presented on a gross basis.

Management considerations

- It is important to identify and have an understanding with regard to the definitions of each type of benefit. The terms/conditions of the benefit should be set accordingly. This is of importance, because the accounting treatment will be according the terms, conditions and the impact to the financial statements can vary.

Company XYZ has a fund for vacation pay. Any surplus in the fund is used to make pension payments. As per this plan benefits can be paid both during and after employment and hence, should be treated as a long-term employee benefit plan rather than as a post-employment benefit plan.

The terms of an early retirement arrangement require evaluation to determine whether the arrangement, or part of the arrangement, is a post-employment benefit rather than a termination benefit.

Long term disability benefits can be treated as post employment benefits as opposed to long term employee benefits

- It is important to decide on the frequency of actuarial valuations. It should be regular enough for the amounts recognised in the financial statements not to differ from the amounts that would be determined at the reporting date.

- Due consideration of future developments should be considered in setting some accounting policies with regard to actuarial accounting.

If an entity’s existing accounting policy is immediate recognition of actuarial gains and losses in profit or loss or other comprehensive income, the standard in substance may not provide for future change in accounting policy to recognise actuarial gains and losses under the ‘corridor’ approach as this does not provide reliable and more relevant information about the effects of transactions.

The new proposals remove the option of using ‘corridor’ method for recognising actuarial gains and losses. Instead it requires actuarial gains/losses to be recognised in other comprehensive income. Hence, it is important that when accounting policies are set, the same is considered. Otherwise transitional changes would have to be done.

This would also have an impact for businesses currently recognising actuarial gains (losses) through P&L, as now these would have to be recognised through OCI.

- It is important to establish whether a change in the defined benefit obligation is as a result of a change in the benefit or is it an actuarial gain/loss. The accounting treatment will have to follow the classification above. If it is a change in benefit, it would have to be accounted as negative past service cost; however, if it was due to actuarial gain/loss, the accounting principles for actuarial gain/loss should be applied. Hence, the impact to the financial statements is different.
• When providing for gratuity in the current year, factors such as discount rates/interest rates, staff turnover, annual increments etc, need to be used in arriving at the future obligation.

Disclaimer
This document is compiled with the objective of presenting a basic overview of the respective Sri Lanka Accounting Standard, and does not construe professional advice in application of the standard. For specific application and understanding of all facets of the standard, the relevant Sri Lanka Accounting Standard issued by The Institute of Chartered Accountants of Sri Lanka should be referred.

References and Useful web-links pertaining to Accounting Standards (Click below links to access)

http://www.kpmg.com

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