

EMPLOYEE BENEFITS (LECTURE A631 – 10.03 MINUTES)

Employee benefits are dealt with in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 28 *Employee Benefits*. Micro-entities reporting under FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* are required to follow the provisions in Section 23 *Employee Benefits*.

Section 28 of FRS 102 outlines the accounting treatment for all forms of consideration provided to an employee with the exception of share-based payments, which are dealt with in Section 26 of FRS 102 *Share-based Payment*.

The term 'employee benefits' is defined in the Glossary to FRS 102 as:

'All forms of consideration given by an entity in exchange for service rendered by employees.'

FRS 102 Glossary
employee benefits

There have been few changes made to Section 28 as a result of the recent triennial review and the changes made to Section 28 are summarised as follows:

Paragraph number	Amendment made
28.1	Removal of the definition of 'employee benefits' as this is contained in the Glossary.
28.15(b)	Reference to the fair value guidance in the Appendix to Section 2 <i>Concepts and Pervasive Principles</i> rather than paragraphs 11.27 to 11.32.
28.21A	Reference to current <u>reporting</u> period rather than just 'current period'.
28.28	Clarification that the cost of a defined benefit plan recognised in accordance with paragraph 28.23 may be presented net of the amounts relating to changes in the carrying amount of the right to reimbursement.
28.30	Clarification that the entity recognises the <u>net change</u> in the liability <u>during the period</u> unless FRS 102 requires or permits the change to be included in the cost of an asset. It then provides examples as to which types of assets (inventory or

	property, plant and equipment).
28.38	Clarification that it is the 'sponsoring employer's' financial statements which takes the cost of a defined benefit plan where there is no agreement or policy stating how the cost is to be allocated in a group. There is also additional clarification that the recognition of the defined benefit cost requires the recognition of a corresponding net defined benefit asset or liability in the individual financial statements of any group entity recognising a net defined benefit cost.
28.41	Changes to the wording. Rather than refer to 'defined multi-employer benefit plans', they are now referred to as 'multi-employer defined benefit plans.'

1.1 Scope of Section 28

Paragraph 28.1 of FRS 102 outlines the scope of the section. Section 28 applies to all employee benefits, except share-based payment arrangements (see Section 26). Employee benefits include:

- (a) short-term employee benefits (other than termination benefits) which are expected to be settled by the entity in full before 12 months after the balance sheet date in which the employee renders the service;
- (b) post-employment benefits (retirement benefits) which are employee benefits, other than termination and short-term employee benefits, which are payable after the completion of employment;
- (c) other long-term employee benefits, which are all employee benefits, other than short-term employee benefits, post-employment benefits and termination benefits; or
- (d) termination benefits, which are employee benefits provided in exchange for them terminating their employment as a result of:
 - (i) the entity's decision to terminate the employee's employment before the normal retirement date; or

- (ii) the employee decides to accept voluntary redundancy in exchange for those benefits.

Paragraph 28.2 of FRS 102 is shown as '[Deleted]'. The equivalent paragraph 28.2 in the *IFRS for SMEs* clarifies that employee benefits do not include share-based payment arrangements. FRS 102 (March 2018) includes this in the opening paragraph 28.1 hence it would be meaningless to include it again in paragraph 28.2.

1.2 Recognition principle for all employee benefits

The general recognition principle for all employee benefits is that an entity recognises:

- (a) a liability, after deduction of all amounts which have been paid to the employees, or as a contribution to the pension fund. A prepayment is recognised if the amounts paid exceed the liability, provided the excess will lead to a reduction in future payments, or a refund; and
- (b) an expense, unless another part of FRS 102 requires the cost to be recognised elsewhere, e.g. within inventory or property, plant and equipment.

In practice, it is relatively uncommon to recognise the expense within another section of the balance sheet, although this could arise, for example, in development costs where an employee is directly engaged in the production of an intangible asset arising from the development phase where the recognition criteria are met.

1.3 Short-term employee benefits

Paragraph 28.4 of FRS 102 provides four examples of what it considers to be short-term employee benefits as follows:

- (a) wages, salaries and social security contributions;
- (b) paid annual leave and paid sick leave;
- (c) profit-sharing and bonuses; and
- (d) non-monetary benefits (e.g. company cars, medical care and free or subsidised goods or services) for current employees.

It is important not to consider the above examples to be conclusive and regard must be had to paragraph 28.1(a) which states that short-term employee benefits are those benefits which are '... expected to be settled wholly before twelve months after the end of the **reporting period** in which the employees render the related service.' Hence, the scope could be wider than the four examples provided by paragraph 28.4.

Reference to 'short-term' in financial reporting usually implies a period of 12 months or less after the balance sheet date in which the related service is rendered. FRS 102 does not provide specific guidance on the unit of account which should be used to evaluate the period over which the benefit is expected to be settled; for example, whether it should be per individual employee or all employees. It would therefore be acceptable for the entity to assess whether any employees are expected to receive settlement after 12 months from the balance sheet date. Where this is the case, such benefits would be regarded as long-term rather than short-term.

1.4 Measurement of short-term employee benefits

Paragraph 28.5 of FRS 102 (March 2018) states:

FRS 102 para 28.5

'When an employee has rendered service to an entity during the reporting period, the entity shall measure the amounts recognised in accordance with paragraph 28.3 at the undiscounted amount of short-term employee benefits expected to be paid in exchange for that service.'

The cost of the above is measured at the cost **to the employer** of providing the benefit.

1.5 Short-term compensated absences

One of the most notable differences between Section 28 of FRS 102 and previous UK GAAP is the need to make an accrual for short-term compensated absences accrued by the employee, but not paid until after the balance sheet date. The most common type of short-term compensated absence is holiday pay (although paragraph 28.6 of FRS 102 also cites sick leave as well).

Paragraph 28.6 of FRS 102 states that an entity must recognise the expected cost of accumulating compensated absences when the employees render service that increases their entitlement to future compensated absences. The term 'accumulating compensated absences' is defined in the Glossary to FRS 102 as:

'Compensated absences that are carried forward and can be used in future periods if the current period's entitlement is not used in full.'

*FRS 102 Glossary
accumulating
compensated
absences*

In respect of such compensated absences, the entity measures these at the undiscounted additional amount which the entity expects to pay and will recognise these as current liabilities.

Generally, companies will recognise items such as unpaid holiday pay when the holiday year is not coterminous with the financial year; or when employees can carry forward a certain number of days holiday to the next holiday year.

Example – Holiday year coterminous with the financial year

Smallco Ltd has an accounting reference date and holiday year of 30 June. An employee is entitled to 30 days holiday per year and can carry forward up to five days holiday into the next holiday year. At the year-end 30 June 2018, an employee has taken 27 days holiday.

An accrual is made for three days holiday entitlement which will be taken in the next accounting period.

Example – Holiday year not coterminous with the financial year

Smallco Ltd has a year-end of 30 June 2018 and a holiday year which ends on 31 December 2018. An employee is entitled to 30 days holiday per year and at the financial year-end had taken 20 days of their entitlement.

A prepayment of five days holiday will be made in the financial statements for the year-ended 30 June 2018 $((30 \text{ days} \times 6/12) - 20 \text{ days})$.

Paragraph 28.7 of FRS 102 states that an entity must recognise the cost of other **non-accumulating** compensated absences when the absences occur. The cost of such absences is measured at the undiscounted amount of salaries and wages paid or payable for the period of the absence.

In some cases, absences such as sick leave, may not be carried forward if they are unused (this applies to most entities). Where the balance cannot be carried forward to the next financial year/accounting period, no obligation is recorded in the financial statements.

1.6 Profit-sharing and bonus plans

Many entities provide profit-sharing and bonus plans to their employees and it is important that such arrangements are correctly accounted for in the financial statements. Paragraph 28.8 of FRS 102 outlines the recognition criteria for such arrangements and the expected cost of profit-sharing and bonus payments can only be recognised in the financial statements when:

- (a) *the entity has a present legal or **constructive obligation** to make such payments as a result of past events (this means that the entity has no realistic alternative but to make the payments); and*
- (b) *a reliable estimate of the obligation can be made.'*

FRS 102 para 28.8(a) and (b)

The above recognition criteria may be familiar because they are consistent with the recognition criteria for a provision in the financial statements per Section 21 *Provisions and Contingencies*.

Paragraph 22 of IAS 19 *Employee Benefits* provides more detailed guidance as to when an entity can make a reliable estimate of its legal or constructive obligation.

IAS 19.22 states such a reliable estimate can be made when, and only when:

- (a) *the formal terms of the plan contain a formula for determining the amount of the benefit;*
- (b) *the entity determines the amounts to be paid before the financial statements are authorised for issue; and*
- (c) *past practice gives clear evidence of the amount of the entity's constructive obligation.'*

IAS 19 para 22(a) to (c)

In addition, IAS 19 also provides some useful guidance where the receipt of a profit share is conditional upon the employee remaining in the employment of the entity. In these cases, the plan creates a constructive obligation as the employee renders his/her service which increases the amount that they will receive if they remain in the company's employment until the end of that specified period.

Example - Profit-sharing arrangement containing a vesting condition

Mediumco Ltd has a profit-sharing arrangement in place for its employees. The conditions stipulate that the entity will pay out a share of its profit to employees who serve throughout the year. Should no employees leave the entity during the year, the profit-sharing payment will be 2.5% of profit. The directors have assessed that, based on past experience, the number of staff which will leave the entity during the reporting period will reduce the profit-share to 2% of profit.

In this situation, Mediumco Ltd recognises a liability and an expense equivalent to 2% of profit.

1.7 Defined contribution pension plans

Defined contribution pension plans are dealt with in FRS 102 (March 2018) at paragraphs 28.13 to 28.13A. Defined contribution plans are easier to account for than defined benefit pension plans which are discussed in the next section.

Paragraph 28.13 of FRS 102 states:

'An entity shall recognise the contributions payable for a period:

- (a) *As a liability, after deducting any amount already paid. If contribution payments exceed the contribution due for service before the reporting date, an entity shall recognise that excess as an asset to the extent that the prepayment will lead to a reduction in future payments or a cash refund.*
- (b) *As an expense, unless another section of this FRS requires the cost to be recognised as part of the cost of an asset such as inventories or property, plant and equipment.'*

Paragraph 28.13A of FRS 102 then goes on to deal with contributions to a defined contribution plan which are not expected to be settled wholly within 12 months after the balance sheet date in which the employees render the related service.

Paragraph 28.13A requires the liability to be measured at the present value of the contributions payable using the methodology for selecting a discount rate specified in paragraph 28.17 (i.e. having regard to market yields on high quality corporate bonds). The unwinding of the discount is recognised as a finance cost in profit and loss in the period in which it arises.

In practice, it is unlikely that the provisions in paragraph 28.13A will apply to companies in the UK because legislation governing pension schemes requires contributions to be paid on a prompt basis.

1.8 Defined benefit pension plans

Defined benefit pension plans are dealt with in FRS 102 (March 2018) in paragraphs 28.14 to 28.28. Such plans are complex to account for and they require actuarial information in order that the accounting input and associated disclosures can be made in the financial statements. This part of the course will not look in detail at defined benefit plan accounting, but will aim to flag up those key areas where change has arisen as a result of FRS 102.

FRS 102 is more relaxed in its requirements than previous UK GAAP at FRS 17 *Retirement benefits*. FRS 102 does not require the use of an independent actuary to perform the comprehensive actuarial valuation; nor does it require comprehensive annual valuations to be carried out. In practice, however, it is usually the case that an independent actuary is used and the valuation is obtained annually because the resulting surplus or deficit in the defined benefit pension plan can be significantly different year on year.

The key steps in dealing with a defined benefit pension plan are as follows:

Primary statement	Recognise
Balance sheet	A defined benefit liability, being the net of: <ul style="list-style-type: none"> • the defined benefit obligation; less • plan assets.
Profit and loss	Cost of the plan, including: <ul style="list-style-type: none"> • current cost; • past service cost; and • interest cost.
Other comprehensive income	Remeasurements, including: <ul style="list-style-type: none"> • actuarial gains and losses; • return on plan assets (excluding amounts included in net interest on the net defined liability); and • change in a surplus which is irrecoverable, excluding amounts included in net interest on the net defined liability.

A notable difference between FRS 102 and FRS 17 is the calculation of the interest taken to profit and loss. Under FRS 102, the calculation of the net interest charge is consistent with the requirements in IAS 19 and is essentially the interest cost on the defined benefit obligation less interest income on the plan assets. This excludes the effect of any surplus which is irrecoverable.

Under previous UK GAAP, FRS 17 took into account the expected return on plan assets when calculating the finance cost/credit. The rates used for the expected return on plan assets are generally higher than those on high quality corporate bonds which will usually mean the total pension charge in profit and loss will increase due to the change. As plan assets continue to be measured at fair value, any volatility in profit and loss will usually be compensated for in other comprehensive income.

Surpluses

In many cases, a defined benefit liability will be recognised on the balance sheet. However, some defined benefit plans are in a surplus position and care needs to be taken where the surplus is concerned.

A surplus can only be recognised on the balance sheet if that surplus is recoverable (this is to prevent an asset being recognised which is not recoverable). A surplus will be recoverable either through reduced contributions into the plan going forward; or by way of a refund from the plan.

Paragraph 28.22 of FRS 102 (March 2018) states that a surplus can only be recognised to the extent that the entity is able to recover the surplus. If the surplus is irrecoverable, it cannot be recognised. Any change in the amount of a defined benefit plan surplus which is not recoverable is recognised in other comprehensive income.

Careful scrutiny of the plan's agreement or Trust Deed will be needed where a plan surplus arises to check on the recoverability (or otherwise) of the surplus. A summary of the accounting treatment for a defined benefit pension plan is shown overleaf.

Group plans

At least one member in the group has to apply defined benefit accounting under FRS 102. Where there is a contractual agreement or stated policy for charging the net defined benefit cost, the individual financial statements of the group member recognises the cost so charged. If there is no such policy or agreement, the net defined benefit cost is recognised in the individual financial statements of the group entity which is the sponsoring employer for the plan.

The other group entities then recognise a cost equal to their contribution payable for the period.

Presentation (deferred tax)

Under previous FRS 17, defined benefit plans were presented in the balance sheet net of deferred tax consequences. There were specific rules which said that deferred tax attributable to the defined benefit pension plan were not to be aggregated and presented with other deferred tax assets and liabilities.

Paragraph 29.23 of FRS 102 states that an entity presents deferred tax liabilities within provisions for liabilities and deferred tax assets within debtors, unless it has chosen to present an adapted balance sheet.

FRS 102 is unclear as to whether an entity should present the gross asset or liability at the foot of the balance sheet. In practice, a net defined benefit liability is included at the foot of the balance sheet in much the same way as it was under previous FRS 17. Where deferred tax is concerned, it seems that most practitioners are defaulting to the actual wording in FRS 102 and including these within other deferred tax balances.

Summary of the accounting treatment for a defined benefit plan

	P&L	OCI	Plan assets	Plan liabilities	Plan deficit
Bal b/f 01.01.18			X	(X)	(X)
Contributions			X		X
Current service cost	X			(X)	(X)
Past service cost	X			(X)	(X)
Net interest on defined benefit liability	X		X	(X)	(X)
Actuarial gain or loss		X		(X)	(X)
Return on plan assets		(X)	X		X
Benefits paid			(X)	X	-
Bal c/f 31.12.18			<u>X</u>	<u>(X)</u>	<u>(X)</u>

1.9 Other long-term employee benefits

Paragraph 28.29 of FRS 102 (March 2018) provides examples of long-term employee benefits which are not expected to be settled wholly before 12 months after the balance sheet date in which the employees render the related service as follows:

- (a) *long-term paid absences such as long-service or sabbatical leave;*
- (b) *other long-service benefits;*
- (c) *long-term disability benefits;*
- (d) *profit-sharing and bonuses; and*
- (e) *deferred remuneration.'*

FRS 102 para 28.29
(a) to (e)

An entity will usually present other long-term employee benefits as creditors: amounts falling due after more than one year. It should be emphasised that where the employee benefit is presented (i.e. as either current or long-term) is based upon whether the entity has an **unconditional right** to defer settlement for at least 12 months from the balance sheet date so careful scrutiny of the transaction will be necessary to ascertain if this unconditional right to defer settlement for at least 12 months from the balance sheet date exists.

Paragraph 28.30 provides the accounting treatment for the liability, which is measured at the net total of the following amounts:

- (a) the present value of the benefit's obligation at the balance sheet date (calculated using the methodology for selecting a discount rate in paragraph 28.17 – i.e. on high quality corporate bonds); *less*
- (b) the fair value at the balance sheet date of the plan assets (if any) out of which the obligations are to be settled directly.

Changes in the liability are recognised in profit and loss, except to the extent that FRS 102 requires, or permits, the change to be included in the cost of an asset.

A notable difference between the accounting for a defined benefit plan and the accounting for long-term employee benefits is that all changes are recognised in profit and loss (unless the change is taken to the balance sheet to an asset such as inventory or property, plant and equipment). Remeasurement components in a defined benefit plan are taken to other comprehensive income, which is not the case for long-term employee benefits.

1.10 Termination benefits

Termination benefits are always recognised in profit and loss. They are not included in the cost of any assets because they do not provide the entity with any future economic benefits.

A commitment to pay termination benefits by the entity may arise because of legislation or other contractual terms. Usually, when an employee's employment is terminated prior to retirement, the employee will be entitled to some form of termination payment (eg pay for services rendered up to the date of termination, unpaid holiday pay and a curtailment of retirement benefits/other employee benefits). They arise due to the entity terminating the employee's service rather than arising from the employee's rendering of services.

Paragraph 28.34 of FRS 102 says that an entity recognises termination benefits as a liability and as an expense only when the entity is demonstrably committed:

- (a) *to terminate the employment of an employee or group of employees before the normal retirement date; or*
- (b) *to provide termination benefits as a result of an offer made in order to encourage voluntary redundancy.'*

FRS 102 para 28.34
(a) and (b)

Paragraph 28.35 of FRS 102 then confirms that an entity is demonstrably committed to a termination only when the entity has a detailed formal plan for the termination and is without realistic possibility of withdrawal from the plan.

Measurement of termination benefits

An entity measures termination benefits at the best estimate of the expenditure which would be required to settle the obligation at the balance sheet date. Where offers are made to encourage voluntary redundancy, the obligation is measured based on the number of employees expected to accept the offer.

In cases where termination benefits are due more than 12 months after the balance sheet date, they are discounted to present value using the methodology for selecting a discount rate specified in paragraph 28.17 (i.e. having regard to market yields at the balance sheet date on high quality corporate bonds).