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IAS 26, Accounting and Reporting by Retirement Benefit Plans - A Closer Look

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International Accounting Standard (IAS) 26, *Accounting and Reporting by Retirement Benefit Plans*, prescribes the principles for reporting of retirement benefit plans. Retirement benefit plans are sometimes referred to by various other names, such as 'pension schemes', 'superannuation schemes' or 'retirement benefit schemes'. In July 1985, the International Accounting Standards Committee (IASC) issued the Exposure Draft E27, *Accounting and Reporting by Retirement Benefit Plans*. In January 1987, the IASC issued IAS 26, *Accounting and Reporting by Retirement Benefit Plans*, operative for financial statements of retirement benefit plans covering periods beginning on or after January 1, 1988. In 1994, the IASC reformatted IAS 26. In April 2001, the International Accounting Standards Board (IASB) resolved that all Standards and Interpretation issued under previous Constitutions continued to be applicable unless and until they were amended or withdrawn.

Objective

The objective of IAS 26 is to specify measurement and disclosure principles for the reports of retirement benefit plans. All plans should include in their reports a statement of changes in net assets available for benefits, a summary of significant accounting policies and a description of the plan and the effect of any changes in the plan during the period.

Retirement benefit plans are normally described as either defined contribution plans or defined benefit plans, each having their own distinctive characteristics. Occasionally plans exist that contain characteristics of both. Such hybrid plans are considered to be defined benefit plans for the purposes of IAS 26.

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For defined contribution plans, the objective of reporting is to provide information about the plan and the performance of its investments.

For defined benefit plans, the objective of reporting is to provide information about the financial resources and activities of the plan that will facilitate an assessment of the relationships between the accumulation of resources and plan benefits over time.

Scope and Application

IAS 26 applies for financial statements of retirement benefit plans, where such financial statements are prepared. It deals with reporting to all participants as a group, and specifically does not deal with reports to individuals about their retirement benefits. IAS 26 does not deal with other forms of employment benefits such as employment termination indemnities, deferred compensation arrangements, long service leave benefits special early retirement or redundancy plans, health and welfare plans or bonus plans. It also does not deal with government social security type arrangements.

IAS 26 regards a retirement benefit plan as a reporting entity separate from the employers of the participants in the plan. All other standards apply to financial statements of retirement benefit plans to the extent that they are not superseded by IAS 26. Note that IAS 19, *Employee Benefits* is concerned with the determination of the cost of retirement benefits in the financial statements of employers having plans. Hence IAS 26 complements IAS 19.

Retirement benefit plans with assets invested with insurance companies are subject to the same accounting and funding requirements as privately invested arrangements. Accordingly, they are within the scope of IAS 26 unless the contract with the insurance company is in the name of a specified participant or a group of participants and the retirement benefit obligation is solely the responsibility of the insurance company.

Many require the creation of separate funds, which may or may not have separate legal identity and may or may not have trustees, to which contributions are made and from which retirement benefits are paid. IAS 26 applies regardless of whether such a fund is created and regardless of whether there are trustees.

Some retirement benefit plans have sponsors other than employers; IAS 26 also applies to the financial statements of such plans.

Key Definitions

Retirement benefit plans are arrangements whereby an entity provides benefits for employees on or after termination of service (either in the form of an annual income or as a lump sum) when such benefits, or the contributions towards them, can be determined or estimated in advance of retirement from the provisions of a document or from the entity's practices.

Defined contribution plans are retirement benefit plans for which the amounts to be paid as retirement benefits are determined by contributions to a fund together with investment earnings thereon.

Defined benefit plans are retirement benefit plans under which amounts to be paid as retirement benefits are determined by reference to a formula usually based on employees' earnings and / or years of service.

Funding is the transfer of assets to an entity (the *fund*) separate from the employer's entity to meet future obligations for the payment of retirement benefits.

Participants are the members of a retirement benefit plan and others who are entitled to benefits under the plan.

Net assets available for benefits are the assets of a plan less liabilities other than the actuarial present value of promised retirement benefits.

Actuarial present value of promised retirement benefits is the present value of the expected payments by a retirement benefit plan to existing and past employees, attributable to the service already rendered.

Vested benefits are benefits, the rights to which, under the conditions of a retirement benefit plan, are not conditional on continued employment.

Prescribed Accounting Treatment

Defined contribution plans

The financial statements of a defined contribution plan shall contain a statement of net assets available for benefits and a description of the funding policy.

Under a defined contribution plan, the amount of a participant's future benefits is determined by the contributions paid by the employer, the participant, or both, and the operating efficiency and investment earnings of the fund. An employer's obligation is usually discharged by contributions to the fund. An actuary's advice is not normally required although such advice is sometimes used to estimate future benefits that may be achievable based on present contributions and varying levels of future contributions and investment earnings.

The participants are interested in the activities of the plan because they directly affect the level of their future benefits. Participants are interested in knowing whether contributions have been received and proper control has been exercised to protect the rights of beneficiaries. An employer is interested in the efficient and fair operation of the plan.

The objective of reporting by a defined contribution plan is periodically to provide information about the plan and the performance of its investments. That objective is usually achieved by providing financial statements including the following:

- (a) a description of significant activities for the period and the effect of any changes relating to the plan, and its membership and terms and conditions;
- (b) statements reporting on the transactions and investment performance for the period and the financial position of the plan at the end of the period; and
- (c) a description of the investment policies.

Defined benefit plans

The financial statements of a defined benefit plan shall contain either:

- (a) a statement that shows:
 - (i) net assets available for benefits,
 - (ii) actuarial present value of promised retirement benefits, distinguishing between vested benefits and non-vested benefits, and
 - (iii) resulting excess or deficit
- (b) a statement of net assets available for benefits including either
 - (i) note disclosing actuarial present value of promised retirement benefits, distinguishing between vested benefits and non-vested benefits, or
 - (ii) a reference to this information in an accompanying actuarial report

The actuarial present value of promised retirement benefits shall be based on the benefits promised under the terms of the plan of service rendered to date based on either current salary levels or projected salaries. Disclosure of the basis is necessary. Changes in actuarial assumptions with significant effect on the actuarial present value of promised retirement benefits shall also be disclosed.

The financial statements shall explain the relationship between the actuarial present value of promised retirement benefits and the net assets available for benefits, and the policy for the funding of promised benefits.

Under a defined benefit plan, the payment of promised retirement benefits depends on the financial position of the plan and the ability of contributors to make future contributions to the plan as well as the investment performance and operating efficiency of the plan.

A defined benefit plan needs the periodic advice of an actuary to assess the financial condition of the plan, review the assumptions and recommend future contribution levels.

The objective of reporting by a defined benefit plan is periodically to provide information about the financial resources and activities of the plan that is useful in assessing the relationships between the accumulation of resources and plan benefits over time. This objective is usually achieved by providing financial statements including the following:

- (a) a description of significant activities for the period and the effect of any changes relating to the plan, and its membership and terms and conditions;
- (b) statements reporting on the transactions and investment performance for the period and the financial position of the plan at the end of the period;
- (c) actuarial information either as part of the statements or by way of a separate report; and
- (d) a description of the investment policies.

Actuarial present value of promised retirement benefits

The present value of the expected payments by a retirement benefit plan may be calculated and reported using current salary levels or projected salary levels up to the time of retirement of participants.

The reasons given for adopting a current salary approach include:

- (a) the actuarial present value of promised retirement benefits, being the sum of the amounts presently attributable to each participant in the plan, can be calculated more objectively than with projected salary levels because it involves fewer assumptions;
- (b) increases in benefits attributable to a salary increase become an obligation of the plan at the time of the salary increase; and
- (c) the amount of the actuarial present value of promised retirement benefits using current salary levels is generally more closely related to the amount payable in the event of termination or discontinuance of the plan.

The reasons given for adopting a projected salary approach include:

- (a) financial information should be prepared on a going concern basis, irrespective of the assumptions and estimates that must be made;
- (b) under final pay plans, benefits are determined by reference to salaries at or near retirement date; hence salaries, contribution levels and rates of return must be projected; and
- (c) failure to incorporate salary projections, when most funding is based on salary projections, may result in the reporting of an apparent over funding when the plan is not over funded, or in reporting adequate funding when the plan is under funded.

The actuarial present value of promised retirement benefits based on current salaries is disclosed in the financial statements of a plan to indicate the obligation for benefits earned to the date of the financial statements. The actuarial present value of promised retirement benefits based on projected salaries is disclosed to indicate the magnitude of the potential obligation on a going concern basis which is generally the basis for funding. In addition to disclosure of the actuarial present value of promised retirement benefits, sufficient explanation may need to be given so as to indicate clearly the context in which the actuarial present value of promised retirement benefits should be read. Such explanation may be in the form of information about the adequacy of the planned future funding and of the funding policy based on salary projections. This may be included in the financial statements or in the actuary's report.

Frequency of actuarial valuations

In many countries, actuarial valuations are not obtained more frequently than every three years. Where actuarial valuation has not been prepared at the date of the financial statements, the most recent valuation shall be used as a base and the date of the valuation shall be disclosed.

Financial statement content

For defined benefit plans, information is presented in one of the following formats which reflect different practices in the disclosure and presentation of actuarial information:

(a) a statement is included in the financial statements that shows the net assets available for benefits, the actuarial present value of promised retirement benefits, and the resulting excess or deficit. The financial statements of the plan also contain statements of changes in net assets available for benefits and changes in the actuarial present value of promised retirement benefits. The financial statements may be accompanied by a separate actuary's report supporting the actuarial present value of promised retirement benefits;

(b) financial statements that include a statement of net assets available for benefits and a statement of changes in net assets available for benefits. The actuarial present value of promised retirement benefits is disclosed in a note to the statements. The financial statements may also be accompanied by a report from an actuary supporting the actuarial present value of promised retirement benefits; and

(c) financial statements that include a statement of net assets available for benefits and a statement of changes in net assets available for benefits with the actuarial present value of promised retirement benefits contained in a separate actuarial report.

In each format a trustees' report in the nature of a management or directors' report and an investment report may also accompany the financial statements.

Those in favour of the formats described in (a) and (b) believe that the quantification of promised retirement benefits and other information provided under those approaches help users to assess the current status of the plan and the likelihood of the plan's obligations being met. They also believe that financial statements should be complete in themselves and not rely on accompanying statements. However, some believe that the format described in (a) could give the impression that a liability exists, whereas the actuarial present value of promised retirement benefits does not in their opinion have all the characteristics of a liability.

Those who favour the format described in (c) believe that the actuarial present value of promised retirement benefits should not be included in a statement of net assets available for benefits as in the format described in (a) or even be disclosed in a note as in (b), because it will be compared directly with plan assets and such a comparison may not be valid. They contend that actuaries do not necessarily compare actuarial present value of promised retirement benefits with market values of investments but may instead assess the present value of cash flows expected from the investments. Therefore, those in favour of this format believe that such a comparison is unlikely to reflect the actuary's overall assessment of the plan and that it may be misunderstood. Also, some believe that, regardless of whether quantified, the information about promised retirement benefits should be contained solely in the separate actuarial report where a proper explanation can be provided.

IAS 26 accepts the views in favour of permitting disclosure of the information concerning promised retirement benefits in a separate actuarial report. It rejects arguments against the quantification of the actuarial present value of promised retirement

benefits. Accordingly, the formats described in (a) and (b) are considered acceptable under IAS 26, as is the format described in (c) so long as the financial statements contain a reference to, and are accompanied by, an actuarial report that includes the actuarial present value of promised retirement benefits.

Valuation of plan assets

Retirement benefit plan investments shall be carried at fair value. For marketable securities, the fair value is the market value. Where plan investments are held for which an estimate of fair value is not possible (e.g. reliable measurement cannot be achieved), a disclosure explaining the reason for not using fair value is required. Where some investments are carried at amounts other than market value or fair value (e.g. market value obtained from a thinly traded market), fair value (e.g. valuation technique) is generally disclosed, if not carried in the books.

Prescribed Disclosures

Financial statements of a retirement benefit plan (either defined benefit or defined contribution) shall contain the following information:

1. a statement of changes in net assets available for benefits
2. a summary of significant accounting policies
3. a description of the plan and the effect of any changes in the plan during the period

Financial statements provided by retirement benefit plans include the following, if applicable:

- (a) a statement of net assets available for benefits disclosing:
 - (i) assets at the end of the period suitably classified;
 - (ii) the basis of valuation of assets;
 - (iii) details of any single investment exceeding either 5% of the net assets available for benefits or 5% of any class or type of security;
 - (iv) details of any investment in the employer; and
 - (v) liabilities other than the actuarial present value of promised retirement benefits;
- (b) a statement of changes in net assets available for benefits showing the following:
 - (i) employer contributions;
 - (ii) employee contributions;
 - (iii) investment income such as interest and dividends;
 - (iv) other income;
 - (v) benefits paid or payable (analysed, for example, as retirement, death and disability benefits, and lump sum payments);
 - (vi) administrative expenses;
 - (vii) other expenses;
 - (viii) taxes on income;
 - (ix) profits and losses on disposal of investments and changes in value of investments;
- and
- (x) transfers from and to other plans;
- (c) a description of the funding policy;

(d) for defined benefit plans, the actuarial present value of promised retirement benefits (which may distinguish between vested benefits and non-vested benefits) based on the benefits promised under the terms of the plan, on service rendered to date and using either current salary levels or projected salary levels; this information may be included in an accompanying actuarial report to be read in conjunction with the related financial statements; and

(e) for defined benefit plans, a description of the significant actuarial assumptions made and the method used to calculate the actuarial present value of promised retirement benefits.

The report of a retirement benefit plan contains a description of the plan, either as part of the financial statements or in a separate report. It may contain the following:

- (a) the names of the employers and the employee groups covered;
- (b) the number of participants receiving benefits and the number of other participants, classified as appropriate;
- (c) the type of plan—defined contribution or defined benefit;
- (d) a note as to whether participants contribute to the plan;
- (e) a description of the retirement benefits promised to participants;
- (f) a description of any plan termination terms; and
- (g) changes in items (a) to (f) during the period covered by the report.

It is not uncommon to refer to other documents that are readily available to users and in which the plan is described, and to include only information on subsequent changes.

Notwithstanding the items which are listed above, any information that supports the objective of reporting or is relevant to all participants as a group shall be disclosed.

Comparative Indian Standard

The Accounting Standard comparative to IAS 26 is under preparation by the Institute of Chartered Accountants of India (ICAI).

Conclusion

Many retirement benefit plans provide for the establishment of separate funds into which contributions are made and out of which benefits are paid. Such funds may be administered by parties who act independently in managing fund assets. In India, the Pension Fund Regulatory and Development Authority (PFRDA) was established in 2003 by Government of India to act as a regulator for the pension sector. As a first step towards instituting pensionary reforms, Government of India and the State Governments moved from a defined benefit pension to a defined contribution based pension system by making it mandatory for its new recruits.
