

**PRIVATE RETIREMENT PLANS
IN THE PHILIPPINES**

FOREWORD

This Study Note intends to provide the actuarial student with an overview of the history, law, and general practice of private retirement plans in the Philippine setting together with a section on the local accounting of retirement benefits.

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Acknowledgment is also hereby extended to Mr. Mabini L. Juan for initiating this project and to Mr. Leonardo B. J. Tan and Mr. Mariano M. Mercado for their valuable comments and inputs.

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HISTORICAL BACKGROUND

The enactment of Republic Act 4917 (RA 4917) on June 17, 1967 spurred the establishment of private retirement plans in the Philippines. Entitled "An act providing that retirement benefits of employees of private firms shall not be subject to attachment, levy, execution or any tax whatsoever," RA 4917 provides, among others, that retirement benefits earned from a reasonable private benefit plan shall be exempt from all taxes provided that the retiree meets certain conditions. The Act further provides that benefits arising from cases of involuntary separation such as death or disability shall likewise be tax-exempt regardless of the plan member's age and years of service.

The promulgation of RA 4917 gave a big boost to companies putting up retirement plans for their employees. For 14 years, RA 4917 and its implementing rules, RR No. 1-68, were the only laws and regulations relevant to private retirement benefit plans. During this period, the trust departments of banks held many of the retirement funds. While there were insured plans, i.e., retirement funds held under the deposit administration arrangement by insurance companies, advantages were accorded the trustee, as against insured, plans in terms of tax-exemption benefits. The BIR issued a ruling that only trustee plans are fully entitled to the tax benefits provided by RA 4917. Up to this writing, this ruling stays. Many banks used this tax advantage to encourage their clients to set up retirement plans and the corresponding retirement trust funds.

On October 28, 1982, the BIR issued Revenue Regulations No. 1-83 which required, among others, the filing of an annual information return on the retirement fund by its trustees or fiduciaries. While BIR Regulations 1-83 merely required the annual filing of information return, it somehow contributed to the growth of retirement funds as the annual review and examination, not only on the part of the BIR but more so on the part of the trustees and the plan sponsors, has

become a regular activity and the retirement programs have not merely been allowed to hibernate for years after they have been set up.

Internal Revenue Regulations No. 1-83 also introduced the requirement for an actuarial valuation in the case of fixed benefit type of plans. An independent actuary who must be a Fellow of the Actuarial Society of the Philippines must certify the valuation. However, this requirement is imposed only during registration of retirement plans and not subsequently (unless the plan is amended, in which case there would be a need to re-file the plan and submit another valuation).

For the most part, the laws so far regulating private retirement benefit plans and funds were passed to provide incentives to private companies to put up retirement plans and set aside retirement funds for their employees that the same may be available when these employees reach retirement age.

Twenty-five years after the first Republic Act giving incentives to companies for establishing private retirement benefit plans, a milestone marked the history of retirement planning in the Philippines. This time, the setting up of retirement plans and retirement funds was not merely encouraged with the grant of tax incentives. On July 27, 1992, RA No. 7641 was signed. This Act, entitled "An Act amending Article 287 of Presidential Decree No.442, as amended, otherwise known as the Labor Code of the Philippines, by providing for retirement pay to qualified private sector employees in the absence of any retirement plan in the establishment," provided, among others: (a) the compulsory payment of retirement benefits to employees; and (b) that the retirement benefit shall at least be one-half month's salary for every year of service (how RA No. 7641 defines 'one-half month salary' is discussed in a later section). Hence, whether a formal retirement plan has been set up or not, the payment of retirement benefits was made compulsory for qualified retirees and a minimum amount of retirement

benefit was specified. If the retiree is entitled to a higher benefit under a retirement plan of the company, then he will be entitled to this higher benefit in lieu of that provided by RA 7641.

In between the enactment of these two Republic Acts, namely, RA 4917 and RA 7641, the HDMF or Home Development Mutual Fund, more popularly known as Pag-IBIG Fund, was organized by the government in 1979 primarily to provide for two major needs of government and private employees, namely, (a) retirement fund by way of forced contributions/savings from employers/employees, and (b) housing loans. Company membership to HDMF then was voluntary.

On September 1, 1995, membership to HDMF was made compulsory but membership exemption was allowed for companies, which have both a retirement program and a housing loan facility for their employees. Implemented through HDMF Circular No. 124 entitled "Guidelines and Procedure for Filing Applications for Waiver or Suspension of Fund Coverage under PD No. 1752, as Amended by Republic Act No. 7742", companies with both a retirement program and a housing plan or loan facility for their employees which are superior to those provided by HDMF shall be exempt from compulsory coverage under HDMF. To concerned companies the exemption will save them the contributions exacted by HDMF. The criteria for getting an exemption from membership to the HDMF are so stringent that it is very difficult to get a waiver of coverage.

TYPES OF RETIREMENT PLANS

Retirement plans generally fall into one of three (3) categories: defined benefit, defined contribution, or hybrid (combination of defined benefit and defined contribution).

Defined benefit plans are plans wherein the benefits to be received by the members are defined by formulas fixed in the plan rules while an actuary estimates the contributions necessary to meet the promised benefits periodically.

From the employer's perspective, a defined benefit plan has the following advantages. First, there is more flexibility in funding, as there are several acceptable funding alternatives to choose from. Second, if the employer has a specific target benefit level in mind, this can be easily met by expressing the benefit in terms of a formula. In the Philippine context, defined benefit is the most prevalent type of plan among employers, and can be considered as market practice.

However, defined benefit plans have the disadvantage of greater uncertainty in the long-term plan costs as the benefits are, in most cases, based on future salaries. Also, since the employer promises a fixed benefit, the employer bears the investment risks pertaining to retirement fund performance. Another concern in defined benefit lump sum plans is the possible significant increase in liabilities for unfunded accrued benefits upon company closure.

In a **defined contribution plan**, employer contributions are fixed in the plan rules. A separate account is maintained for each member to which all contributions and earnings on these contributions are credited. The benefits are a function of both the total contributions made and the investment performance of the fund.

Under a defined contribution plan, the benefits are variable and thus cannot be quantified at the onset in terms of final salary and service at retirement. Each employee's level of benefit may be unique, as benefits are dependent on the total contributions made, investment earnings of the fund, salary increases and timing of salary increases and the number of years of contributions. Because of the foregoing factors, the benefits could either fall short or exceed an employer's specific income replacement objective.

A defined contribution plan has several advantages from the employer's standpoint. The cost of the plan is more predictable as it is based on a formula such as a fixed percentage of salary. As the benefit is based on the accumulated value of contributions and earnings on these contributions, the investment risk of meeting the target benefit at retirement is borne by the employees.

On the negative side, employers have little flexibility in funding as the timing and level of contributions are fixed in the retirement plan rules. There will be greater need for administrative effort, as individual account balances must be maintained for all employees.

There are basically two types of **hybrid plans** – the first type is where the benefits usually come from two sources: (a) defined benefit feature where benefits are based on a fixed formula; and (b) defined contribution feature where benefits are a function of both total contributions made and the investment performance of the fund.

The defined benefit feature usually provides a basic level of benefits while the defined contribution feature provides a supplemental benefit. It is common that the defined contribution feature of a hybrid plan allows voluntary employee

contributions, which are matched by the employer up to a certain limit. This is one way of encouraging employees to save for their retirement.

The second type of hybrid plan is basically a defined contribution plan but guarantees a minimum benefit. This means that the accumulated value of the contributions and interest or losses on these contributions should not fall below a minimum guaranteed benefit as stated in the plan rules. If the individual account balance in the DC plan is less than the guaranteed benefit at the time the benefit is payable, the company puts up the difference.

The hybrid plan combines all the advantages and disadvantages of both the defined benefit and defined contribution plans. If a Company has a specific minimum target benefit level, this is addressed by the benefit formula under the defined benefit feature. This is especially important where there is a minimum mandatory retirement benefit specified such as what we have in the Philippines. If the Company can afford to provide additional retirement benefits, this is addressed through the defined contribution feature of the plan where the cost is more predictable. As far as investment risk is concerned, in the defined benefit feature, the investment risk is borne by the employer while under the defined contribution feature, the investment risk is borne by the employee.

The biggest disadvantage of the hybrid plan is in the cost of administering the plan since periodic actuarial valuations are needed as well as maintenance of individual account balances.

MARKET PRACTICE

This section will provide the student with a guide to the most likely arrangements to be found in the Philippines.

Type of Retirement Plan

Most retirement plans are of the defined benefit type. A major reason for the popularity of defined benefit plans is that the mandatory minimum retirement benefit is also defined benefit in nature. There are a few but significant defined contribution plans in the market, usually sponsored by prominent multinationals. The hybrid plan is slowly gaining ground with the addition of a defined contribution feature to the defined benefit plan.

Manner of Benefit Payments

Most, if not all, retirement plans provide for immediate lump sum benefit payment at separation from service. The few plans which pay benefit as a pension are not really so in practice since they contain lump sum commutation options which are, more often than not, exercised.

Eligibility

Eligibility requirements are generally influenced by the tax laws. A qualified retirement plan is required to be non-discriminatory, although different plans or benefit levels are permitted for different groups of employees within certain parameters - for example, plant employees and head office employees.

The most common eligibility requirement is for all regular, full-time permanent employees. A few plans have additional requirements for membership based on a specified period of service, such as one or two years. However, benefit is still

generally reckoned from the date of hire. It is not common to include part-time or probationary employees in the retirement plan.

Service

In the typical defined benefit plan, service is usually counted from the date of hire. Even for a newly established plan, past service is generally is generally considered as part of total service.

Service often also includes periods of employment with associated companies. However, there are usually provisions, which allow the deduction from plan service of certain periods, such as extended leaves without pay.

Salary

For benefit calculation purposes, salary is usually the regular basic monthly salary, even if employers are obliged under the law to pay 13 months of salary per year and some even pay 14 or more months. Other components of variable pay such as bonuses and allowances are oftentimes excluded. At times, if a significant component of salary comes from commissions, some plans include commissions that are averaged over a certain period as part of the salary basis for determining benefit under the plan.

Majority of defined benefit plans determine the benefits payable based on final salary. A minority of plans average salary over the preceding 12 months. Longer averaging periods are even less common and career-average plans are very rare.

Retirement Age

The normal retirement age is usually age 60. Distinction between male and female retirement ages is rare.

Early retirement eligibility is generally patterned after the minimum eligibility for tax-free benefits, that is, age 50 with at least 10 years of service. Some plans require an older age requirement or longer service requirement or both.

Late retirement, usually requiring yearly consent from the employer is also common. However, this does not extend beyond age 65.

Normal or Late Retirement Benefit

Due to the prevalence of defined benefit plans, a standard retirement plan in the Philippines is one that provides a retirement benefit based on a multiple of final monthly basic salary per year of service.

A new development is the introduction of a defined contribution feature to a basically defined benefit plan. Under this scheme, it is not uncommon to allow voluntary employee contribution which will be matched by the employer. Usually, the more senior and higher-paid employees take advantage of this option. Moreover, since this type of improvement is commonly prospective in nature, it does not give rise to past service liabilities in the way that an improvement in the defined benefit formula would.

Early Retirement Benefit

Early retirement benefits generally have the same formula as normal retirement benefit, with service and salary as of the date of early retirement. Some plans

would have some deduction for each year that the actual early retirement date precedes the normal retirement age.

Defined contribution plans commonly pay the full member's account balance upon early retirement.

Death and Disability Benefits

The most common benefit upon death or total and permanent disability is the accrued normal retirement benefit. As with all other benefits, this is usually paid in lump sum.

Most companies with retirement plans also maintain group life insurance programs. There is usually little attempt to integrate the two, i.e., the employee gets a benefit from both the retirement plan and from the group life insurance program upon death or disability. If the retirement and life insurance programs are integrated, the retirement plan usually provides for the payment of the excess, if any, of the accrued retirement benefit over the amount of coverage under the group life insurance policy.

Voluntary Resignation Benefit

Most plans would generally have voluntary resignation benefit provisions. The benefit is usually determined by applying a vesting schedule, which increases with length of service.

Vesting usually starts at either five or ten years of service, and the accrued retirement benefit is usually fully vested after 20 years of service.

Involuntary Separation Benefit

The Labor Code requires employers to provide benefits upon involuntary separation due to retrenchment or redundancy. The Labor Code allows the employer to satisfy his obligation in whole or in part by a payment from a retirement plan. Therefore, it is common to include this provision within the retirement plan.

The benefit payable upon involuntary separation (other than dismissal for cause) is generally the greater of the benefit the employee is entitled to under the plan and the amount mandated by the Labor Code based on the circumstances of termination.

Other Benefits

A facility for member loans, at concessional interest rates, is occasionally found. Because of problems with cross-subsidization, these loans are usually restricted to defined contribution plans.

Member Contributions

Most retirement plans are funded entirely by the employer. Member contributions are usually only found in defined contribution plans or hybrid plans which allow optional member contributions. Member contributions to retirement plans are not considered tax deductible expenses of the employer.

Plan Termination

Upon termination of retirement plan, most plans provide for a priority in paying retirement benefits to the extent they are funded. The usual prioritization is:

- a. Members whose employment has been terminated by reason of retirement, death, or total and permanent disability but whose benefits are still due and payable at the date of termination.
- b. Members eligible for retirement.
- c. Members involuntarily separated (except for just cause).
- d. Members who have not received the full amount of their benefits accrued at date of termination or discontinuance of the plan determined using the same formula as in the retirement benefit.

Any plan asset remaining after satisfying (a), (b), (c) and (d) above reverts to the company.

LEGAL ISSUES

Minimum Retirement Benefits

The legal issues regarding retirement benefits arise mainly from Republic Act 7641. This law took effect in January 7, 1993 and amended a portion of the Labor Code dealing with retirement benefits. It mandated the payment of a minimum level of retirement pay by private companies to their employees. This law exempted government employees, domestic helpers, persons in the personal service of another, and employees of retail, service and agricultural establishment regularly employing not more than 10 employees.

In companies with retirement plans or collective bargaining agreements, the terms of such plans or agreements were to be followed with respect to the eligibility for benefits. However, the benefits should not fall below those prescribed by this law. So if a private retirement plan allows early retirement at, say age 50, the benefits offered must meet the legal minimum because this is a case of retirement. This is critical in retirement plans, which feature stepladder benefits based on age and/or tenure.

We find in actual practice though that there are plans that call any withdrawal before retirement at age 60 as "early retirement" or "optional retirement" although they really refer to resignation benefits. Such plans may be exposed to the minimum under R.A. 7641 although this is still a gray area as of now. It would be advisable for these plans to distinguish between resignation benefits and early retirement to avoid the potential risk of having to comply with the minimum on what are intended to be resignation benefits.

In the absence of a retirement plan or any similar agreement, employees may retire and be qualified for the benefits under R.A. 7641 if they have reached the

age of at least 60 but not beyond 65 and had served in their respective companies for at least 5 years. In these cases, it is the employees' right to demand to be retired and be given the benefits prescribed by R.A. 7641. The law also set the compulsory retirement age at 65, which means that companies have the right to retire the employees if they reach this age.

The minimum benefit prescribed by R.A. 7641 was defined as "one-half month salary per year of service, a fraction of at least six months being considered as one year. The term 'one- half month salary' shall mean fifteen (15) days plus one-twelfth (1/12) of the 13th month pay and the cash equivalent of not more than five (5) days of service incentive leaves." In the Rules Implementing this law, the Department of Labor and Employment (DOLE) specified that the term "one- half month salary" should include all of the following:

- 15 days salary based on the latest salary rate; plus
- cash equivalent of 5 days service incentive leave; plus
- 1/12 of the thirteenth month pay; and
- all other benefits that the employer and employee may agree upon to be included.

Note that by defining "one-half month salary" as above, the law effectively uses a multiplier, which is more than 50% of a month's pay. The first two items alone already equal 20 days' pay and in companies which use a 24-day month (half day on Saturdays), the minimum is already more than 80% of a month's salary, not counting the last two items yet.

In cases where both the employer and the employee contribute to a retirement fund, the portion of the benefit pertaining to the employer contribution only must meet the legal minimum. This is relevant especially in defined contribution plans where there is usually an employee contribution.

Defined Contribution Plan Issues

Since the law is expressed as a defined benefit, there is another issue with defined contribution plans. In these plans, the benefit at retirement depends principally on the actual investment yield experience, the actual salary increase rate, and the defined contribution rate. Potentially, the eventual benefit may turn out to be lower than the prescribed minimum. Thus, pure defined contribution plans still face a contingent liability for retirement benefits even if they have been funding their retirement plans regularly. For this reason, most local defined contribution plans have set-up minimum benefit guarantees to comply with the legal minimum.

TAX ISSUES

Taxability of Retirement Benefits

Effective January 1, 1998, retirement benefits paid in compliance with RA 7641 were exempted from income tax under Section 32 (B)(6)(a) of the Tax Code of 1997 and Revenue Regulation 2-98. Prior to this date, only retirement benefits coming out of tax-qualified plans were tax-exempt. The tax exemption requires, however, that the retiring official or employee has been in service of the same employer for at least ten (10) years and is not less than fifty (50) years of age at the time of his retirement. Moreover, an official or employee shall avail of the tax benefits only once. Note that the age and tenure requirement under R.A. 7641 are different from that of the Tax Code. For taxation purposes, the provisions of the Tax Code shall prevail.

While the law (R.A. 7641) states a minimum benefit, there is no specific ceiling mentioned in that law. Recall the definition above of "one-half month salary". The fourth item is a catchall phrase ("all other benefits that the employer and employee may agree upon to be included") that can effectively increase the actual amount of the retirement benefit. Therefore, as long as the benefits can be justified as arising from compliance with RA 7641, the retirement benefits would be tax-exempt, subject to the conditions mentioned earlier.

The conditions for tax-qualification actually first came out of an earlier law, Republic Act 4917, which exempted retirement benefits paid out of a "reasonable" retirement benefit plan from any tax whatsoever. The rules implementing RA 4917, Bureau of Internal Revenue (BIR) Revenue Regulations No. 1-68 (RR No. 1-68), issued on March 25, 1968, spelled out the requisites of a reasonable retirement benefit plan, to wit, the retirement benefit plan must be a written permanent program which will qualify at least 70% of the company's

employees. If there are eligibility requirements for plan membership and at least 70% of employees meet the eligibility requirements, at least 80% of those eligible should be actually covered. The following employees though may be excluded in the base for the computation of the percentages: (a) those who have not completed a specified minimum length of service for qualification; (b) part-time employees; and (c) seasonal employees. The regulations strongly disapprove of discrimination in favor of officers, shareholders, supervisors or highly compensated employees.

The BIR subsequently issued Revenue Regulations No. 1-83 which required, among others, the filing of an annual information return of a tax-qualified retirement fund by its trustees or fiduciaries. Said return should contain, among others, the fund's gross income, total fund amount to date, employer's contributions for current and past service, employees' contributions, if any, investment earnings, benefit payments, plan changes and sources and disposition of the trust fund.

Because retirement benefits are considered as welfare benefits just like health and life insurance, employer contributions to the retirement fund are also exempt from fringe benefits tax (Section 33 of the Tax Code). While this may seem redundant in the face of the tax-exempt nature of retirement benefits above, note that there are cases where the earlier-mentioned exemptions are not applicable. Moreover, the tax exemption under Section 32 deals with income tax (which is paid by the employee) while the fringe benefits tax is payable by the employer.

Benefits of Tax Qualification

Republic Act 4917 provided other tax benefits assuming that a retirement plan complies with certain requirements. A retirement plan that complies with these requirements is called a tax-qualified plan.

As mentioned earlier, a tax-qualified plan exempts the retirement benefits of an employee from income tax. For companies sponsoring retirement plans, tax-qualification allows them to deduct their contributions to the retirement fund from their taxable income. Moreover, the earnings of the retirement trust fund are exempt from all taxes as well. These last two tax benefits have encouraged a lot of companies in setting-up tax-qualified plans.

For deductibility of retirement fund contributions, the National Internal Revenue Code (Section 34 (J)) distinguishes between contributions for pension liability accruing during the year and liability accruing in previous years. Contributions for current year costs are fully deductible in the year of contribution while contributions in excess of such (presumed to be for prior years) can be only deducted evenly over a ten-year period starting from the year of contribution (provided they have not been allowed as deductions before).

The exemption of trust fund income from taxes is detailed in Section 60 of the 1997 Tax Code. With this provision, earnings of trust funds are exempt from income taxes. This effectively decreases the cost of funding tax-qualified plans particularly for defined benefit trusteed plans. The cost of these plans are shouldered by both contributions and earnings and, all other things being equal, an increase in one will allow a decrease in the other. Taxes decrease the earnings and exemption from taxes result in increased earnings and consequently reduced contributions from the company. It should be noted

though that Section 60 mandates the taxability of trust fund earnings to the recipient upon actual distribution. This means that if the recipient is not covered by a tax-exempt status (as in the case of a tax-qualified plan or other Section 32 exemptions), then the earnings are taxable upon receipt. In case of the latter, the benefit is tax-deferral rather than exemption.

The BIR in subsequent rulings categorically stated that retirement benefits coming out of non-trusted plans may also be tax-exempt to the employee (subject to the usual conditions mentioned earlier) but the investment income of such plans is not tax-exempt and contributions thereto are not necessarily tax-deductible in the year of contribution. In the case of insured plans, for example, only the premium portion may be claimed as a deduction in the year of contribution. In the case of pre-need plans, the contributions may be fully deductible but the tax on earnings is buried in the lower return implicit in the pricing although this may not be readily apparent to the buyer. Due to the tax advantages of trusted plans, companies seldom use non-trusted plans for retirement benefits.

Tax Qualification Procedures and Requirements

Republic Act 4917 requires certain conditions for bestowing the tax benefits mentioned earlier:

1. a retiring employee must be at least age 50 and has served his employer for at least 10 years;

The only exception to this rule is if the retirement is due to involuntary separation (death, disability, retrenchment or any cause beyond the control of the employee).

2. a retiring official may avail of this tax exemption privilege only once; and,
3. the benefits must come from a reasonable private benefit plan.

Republic Act 4917 defined the term “reasonable private benefit plan” to mean a pension, gratuity, stock bonus or profit sharing plan maintained by an employer for some or all of his employees, wherein contributions are made by the employer and/or employees, for the purpose of distributing to the employees the earnings and the principal of the accumulated fund. It was further required that the plan must not allow any part of the fund to be used for or diverted to any purpose other than for the exclusive benefit of the employees.

In March 1968, the Bureau of Internal Revenue (BIR) released Revenue Regulation 1-68 as the implementing guideline for the implementation of R.A. 4917. The new regulations spelled out the requisites of a “reasonable” retirement benefit plan as follows:

1. it must be a definite written program containing all the provisions essential for tax qualification;
2. it must be a permanent and continuing program;
3. it must cover at least 70% of the employees; if there are eligibility requirements and at least 70% of all employees qualify, then at least 80% of those eligible must be covered. For this purpose, the count does not include employees with less than the minimum tenure required by the plan, employees who work 20 hours a week or less, and seasonal employees who work 5 months a year or less.

The law allows employers who do not wish to cover the majority of their employees to limit the plan to a certain class of employees. However, such classification must not discriminate in favor of officers, shareholders, supervisors or highly compensated employees (restricted group). Thus, a retirement plan exclusively for manager and executives will not be accepted for tax-qualification. For this reason, most

supplementary executive retirement plans are not tax-qualified and usually unfunded as well.

4. the employer and/or the employees shall contribute to a trust fund;
5. the trust fund must be used exclusively for the benefit of the employees;
6. there must be no discrimination on contributions or benefits in favor of the restricted group;
7. accrued benefits in case of termination of the plan or discontinuance of contributions, to the extent then funded, are non-forfeitable. This is why it is important for the employees to have the funding as updated as possible.
8. forfeitures arising from termination of employees prior to retirement may not be used to increase the benefits of the other plan members;
9. the retirement fund must be administered by a trust.

While bank trust departments today administer most retirement funds, it must be noted that the law does not limit it to such entities only. A group of company officers can constitute themselves into a Board of Trustees and administer the retirement fund themselves. A Trust Agreement must be executed just the same.

The trust fund may normally be invested anywhere that the Trust Agreement allows. However, the tax-exemption of the trust income may be denied if the trust:

1. lends without adequate security and a reasonable rate of interest;
2. pays any compensation in excess of a reasonable allowance or other compensation for personal services actually rendered;
3. makes any part of its services available on a preferential basis;
4. buys substantial securities or purchases property for more than what it is worth;
5. sells substantial part of its investments or properties for less than what it is worth;

6. engages in any transaction that results in substantial diversion of the fund to the employer, his family or other corporations controlled by the employer.

Before any tax benefit can be enjoyed, the regulations required the employer to secure a tax-qualification ruling from the BIR. Forms to be submitted included BIR Form 17.60, the plan document and the trust agreement.

FUNDING A RETIREMENT PLAN

Having set up a retirement plan for his employees, the employer is in effect making a promise to his employees, that retirement benefits will be provided to them upon attainment of certain conditions (age and/or years of service). Even without a formal retirement plan, **Republic Act 7641**, also known as the retirement law, mandates all employers to provide a specified minimum level of benefits upon an employee's attainment of age 60 and completion of 5 years of service. In recognition of such requirement, the Accounting Standards Board released Statement of Financial Accounting Standards No. 24 (**SFAS 24**) in May 1996, requiring all accountants to include in financial statements of covered companies the liability for retirement benefits accruing during the fiscal year. International Accounting Standards 19 (IAS 19) replaced SFAS 24 for financial statements starting January 1, 2005.

However, neither Republic Act #7641 nor subsequent accounting standards required the actual setting aside of funds to ensure the payment of benefits promised. Under RA #7641, the requirement is for an employer to provide retirement benefits upon retirement of an employee, regardless of where the funds will come from. On the other hand, the accounting standards require the recognition of a liability, but not necessarily the funding of such liability.

Funding is defined as "*the financing of retirement benefits by setting aside funds for the payment of such benefits in advance of the date on which the benefits become payable.*" The following have been given as reasons for funding:

1. **Security of benefit** - once funds are set aside for the payment of retirement benefits, such funds can be used solely for that purpose. This

prevents the employer from using the funds for other company expenditures. Hence, employees are assured that funds will be readily available upon their retirement from service.

2. **Reduction of employer outlay** - setting aside funds before retirement benefits become due and payable allows the funds to earn tax-free interest during the interim period (per Republic Act #4917), thus effectively reducing the total amount of money spent for retirement benefits.
3. **Management of cash flow** - if funds are set aside on an annual (or more frequent) basis, the impact on the company's cash flow will be small as compared with the case when the full amount of retirement benefits is paid at retirement. This prevents the case where a large retirement benefit is paid in a particular year, thus resulting in a large cash outflow for that year.
4. **Flexibility in financing** - although ideally the retirement cost for a particular year should be funded in that year, there are instances when certain unforeseen circumstances prevent the employer from doing this. Assuming that the funds available are more than sufficient to pay retirement benefits for the current year, the employer may suspend contributions for that year, and just make up for it in future years when economic conditions warrant.
5. **Requirement for tax exemption** - **Among** the requisites of a “reasonable retirement plan” is the requirement that “The employer, or officials and employees, or both shall contribute to a trust fund for the purpose of . . . ”. Before a retirement plan can be tax-qualified, therefore, the plan has to be funded.

In actual practice, employers have a choice as to the funding scheme that they prefer, ranging from “no funding” to “complete funding”:

1. **No funding or “pay-as-you-go”** - there are no funds set aside prior to the actual date of payment of retirement benefits. Hence, upon an employee’s retirement, the company has to produce the amount necessary to fund his retirement benefit. For plans providing for monthly pension payments, the amount may be manageable, but for plans providing for lump sum payments, it may be so large as to result in a negative cash flow for the company for that year.

2. **Terminal funding** - as in 1. above, there are no funds set aside prior to the actual date of payment of retirement benefits, so that the same problem arises. However, in the case of plans providing for monthly pension payments, the total cost of the benefits (i.e., the present value of all future monthly pension payments) is funded, which then results in the same condition as in a lump sum payment. The amount is either used to buy an annuity from an insurance company, or is turned over to a bank for it to pay the future pension benefits. In either case, the employer has no more responsibility in paying future pension benefits.

3. **Level contributions from plan entry age** - using any of the recommended actuarial cost methods, a level contribution rate (or amount) is determined, and the company funds the retirement benefits in periodic installments starting from the time the employee becomes eligible to join the plan. Since benefits are funded throughout the working lifetime of an employee, this funding method produces a relatively low annual contribution, and does not give rise to a past service liability except when there is an increase in benefits.

4. **Immediate funding of initial accrued liability with annual contributions for future service benefits** - an initial accrued liability arises when a retirement plan is set up after some employees have already earned past service credits. This is the cost of benefits arising from the employee's service years with the company prior to the establishment of the retirement plan. If this liability is funded in full at plan inception, then future annual contributions will be reduced.

5. **Funding of initial accrued liability in annual installments, together with contributions for future service benefits** - A variation of the above is to fund the initial accrued liability in annual installments for a specified number of years, or over the average working lifetime of the employees, instead of funding it in full at plan inception. The annual installment is then added to the annual normal cost to get the total amount of contribution for the year.

6. **Full funding at plan entry age** - the total projected retirement benefits of an employee is estimated, then discounted, and the full amount is contributed at the time of entry into the plan. Although theoretically no further contributions are necessary, periodic valuations still need to be done in order to determine the continued applicability of the assumptions used. (This is true also for the funding methods 3,4, 5 and 7.)

7. **Complete funding** - a single sum is deposited initially, such that all future retirement benefits will be paid from interest earnings of the fund, leaving the initial sum intact. As in 6. above, theoretically no further contributions are necessary. However, if interest rates drop drastically, there will be a need to replenish the fund.

In the local setting, number 1 is the most prevalent, especially for companies with less than 50 employees. With the promulgation of the retirement law, some companies that did not have a retirement plan, or those that did not fund their retirement plan, started funding it using either number 3, number 4 or number 5. Numbers 6 and 7 are hardly ever used due to the considerable strain on the company's finances.

In the case of Defined Contribution plans, the company contributes the necessary amount (depending on the contribution rate chosen) regularly starting on the date of plan inception. If retirement benefits due to service prior to plan inception are provided for in the plan, funding of past service credits may be done in one lump sum or amortized during a specified number of years.

Funded ratio - the ratio of the assets of the fund to the present value of liabilities attributable to benefits earned for service to date. Although there is no legal minimum requirement for this ratio, it is prudent to keep it at a level as close to 100% as possible to ensure that funds are readily available to pay retirement benefits when they become due. It is recommended that the assets of the fund should be at least equal to the amount of vested benefits.

TRUSTEED PLANS

Section 2 of Revenue Regulations No. 1-68 (as amended by RR No. 1-83) lists down the requisites of a reasonable retirement plan in order for it to qualify for tax-exempt status. One of these is: "(i) The retirement fund shall be administered by a trust."

A "**trust**" or "**trustee**" may be a natural person(s), or a corporation. *"Any person of legal age and sound mind can serve as a trustee, but only corporations whose charters bestow trust powers upon them may act in that capacity."*

“In general, only banks and trust companies may serve as corporate trustees and even those institutions can act in a fiduciary capacity only if authorized to do so by their charters.

“Natural person trustees are confined to small trust fund plans . . . The trustee of such a plan is usually a director, officer, or employee of the employer corporation or a practicing attorney or accountant retained by the employer. Such a trustee is the “alter ego” of the employer and can be removed at any time by the board of directors. Sometimes, two or more individuals are appointed co-trustees and occasionally a corporate trustee will be designated to serve with one or more individual trustees or as custodian of the assets.”¹

The relationship between the Trustor (often the Retirement Plan administrator or the company itself) and the Trustee is formally defined in a Trust Agreement entered into by the parties. The agreement defines the duties and responsibilities of each of the parties to the contract. Generally, the Trustee has sole discretion on where he would invest the funds entrusted to him. However, it is possible for the Trustor to give specific instructions with regard to where the funds would be invested.

The Trust Fund is credited with all contributions (employer and employee), as well as investment earnings. On the other hand, disbursements consist of benefit payments, trust fees, investment expenses, professional fees for actuaries, lawyers, and/or accountants, and other expenses related to the maintenance of the Fund.

For contributory plans, company contributions are separately accounted for from employee contributions. Although it is generally the company that keeps track of each employee's contribution, the trustee should see to it that the funds coming from employer contributions are kept separate from those coming from employee contributions. Since fund earnings usually increase as the size of the fund

¹Dan M. McGill, *Fulfilling Pension Expectations*, (Homewood, Ill., 1962), pp. 47-48

increases, it is better to set up one large fund rather than two small funds. Instead, some trustees set up two sub-funds under the same trust account. Retirement benefits due a retiring employee according to the company's retirement plan are disbursed from the company contributions sub-fund, while benefits arising from employee contributions are disbursed from the employee contributions sub-fund. At the end of each fiscal year, the total income earned by the fund is allocated proportionately to each sub-fund. In turn, the total income earned by the employee contributions sub-fund is allocated to each employee depending on his balance at the time of distribution.

Defined Contribution plans, where the retirement benefit is the accumulated amount plus investment earnings, are treated in the same way as employee contributions described above. This means that individual accounts are set up for each employee, with the income allocated to each employee on a periodic basis.

Trustees of retirement funds are expected to render quarterly reports to the trustor. At the very least, the report should contain the following:

- (i) the balance in the trust at the beginning and end of the accounting period;
- (ii) contributions received, suitably broken down as to their source (employer vs. employee);
- (iii) investment earnings, reflecting realized capital gains and losses, and the yield at cost, with and without realized capital gains or losses;
- (iv) sums disbursed in the form of benefits, possibly broken down as to recipients;
- (v) charges against the fund, including the trustee's fee;
- (vi) assets acquired and disposed of during the period; and

- (vii) a listing of the specific assets owned by the trust, with details such as date acquired, cost, and current market value.

The plan administrator should see to it that the trustee properly invests the funds, and that the rate of return on investments is within acceptable limits. If the plan administrator is not satisfied with the service of the trustee, he may terminate the Trust Agreement and transfer the funds to another trustee.

When the retirement fund becomes very large, some plan administrators engage more than one trustee.

Trustees in general, whether individual or corporate, do not have the expertise to determine the amount of contributions needed to fund a particular set of benefits. An actuary provides this service. It is therefore necessary for a company to engage the services of an actuary for this purpose.

INSURED PLANS

Some plan administrators prefer to place the funds with an insurance company instead of a trustee. Insurance companies usually provide services which otherwise would be separately contracted for by the plan administrator. This includes the actuarial, legal and accounting functions.

There are various forms of contracts offered by insurance companies as funding instruments for retirement plans.

1. Individual Contract Plan

This is used by small companies, usually with less than 100 employees. Under this funding method, the company buys annuity or insurance

contracts for each individual who is covered under the retirement plan, the amount of which is approximately equal to the monthly pension upon retirement. In the case of retirement plans providing for a lump sum benefit, endowment insurance is used. In case of increases in salary that would affect the amount of retirement benefit, additional contracts will have to be purchased from time to time.

In case of an employee's death before reaching retirement age, the death benefit under the contract becomes payable.

In case the employee resigns prior to reaching retirement age, he gets either nothing or a portion of the benefit, depending on the provisions of the contract.

2. Group Permanent Plan

For companies that would like to provide both retirement and death benefits in one plan, this is the answer. The company buys individual cash value insurance plans (endowment at 60 or 65 are commonly used) for each participant in the retirement plan. The amount is so determined as to be able to provide a specified amount of retirement annuity or lump sum at retirement. Since the insurance company guarantees the amount as well as the delivery of benefits, the employer has no other obligation except to pay the premiums due on the group policy, and update the membership of the plan when necessary.

3. Deferred Group Annuity Contract

This type of contract is best suited to retirement benefits expressed as a unit of benefit per year of service. For example, if a plan provides for a

monthly pension of ₱1,000.00 for each year of credited service, then an annuity for such amount is purchased for each employee every time he completes one year of credited service. As in the Group Permanent Plan, the insurance company is responsible for the delivery of benefits. The employer pays the premium and updates the membership of the plan.

4. Deposit Administration Group Annuity Contract

Unlike the Group Permanent Plan or the Deferred Group Annuity Contract where individual contracts are purchased for each employee, this type of contract does not require the purchase of individual contracts. Instead, the actuary of the insurance company (or a consulting actuary) computes the necessary annual contributions for the whole group, and the company deposits this amount in an unallocated fund. The amount of contributions will vary depending on the composition of the employee-group at the time of computation, as well as on the various assumptions used. It is therefore necessary to have a periodic valuation of the fund in order to assess its sufficiency. Gains or losses due to variances of assumptions from actual experience will affect future employer contributions. Usually, the insurance company guarantees interest earnings for a certain number of years. In some cases, the insurance company shares any excess in interest earnings over the guaranteed rate with the employer.

When an employee retires (or becomes eligible for vested benefits), an amount is withdrawn from the unallocated fund to pay the lump sum benefit, or purchase an annuity for the benefits of such employee.

This type of contract is very similar to the Trusteed Plan earlier discussed, except that the “trustee” is an insurance company, and there is a guarantee on the interest earnings of the fund.

5. Immediate Participation Guarantee (IPG)

This is a variant of the deposit administration plan wherein the employer's account "*automatically reflects adjustments for the actual mortality experience of retired lives, actual investment experience and actual expenses. This is accomplished through charging all benefit and expense disbursements directly to the employer's account and crediting the account with the periodic contributions and interest at a rate based on the actual net rate earned by the insurer on its total investment portfolio, adjusted for realized capital gains and losses.*"²

It is unfortunate that there are no statistical data available regarding the number of companies that make use of insurance companies as funding agencies for their retirement plans. For companies that use them, the more common types are no. 2 and no. 4.

Defined Contribution types of plans are seldom used in insured plans since insurance policies are basically fixed value instruments. However, a defined contribution type of plan may be used, with the amount of retirement benefit determined by the amount contributed (as in a single premium deferred annuity contract). In the case of a Deposit Administration Contract, the amount of retirement benefit is determined by the accumulated amount of contributions at the time of retirement.

Although not common, employee contributions may also be allowed under insured plans. The student is requested to refer to the discussion of contributory plans under Trusteed Plans for further details on this.

²*Fulfilling Pension Expectations*, pp. 44-45

TRUSTEED PLANS VS. INSURED PLANS

In deciding where to invest the funds of a retirement plan, the company has to consider many factors, among which are the following:

1. Investment earnings - One advantage of trustee plans is that they provide the company with greater control of where the funds are invested. Furthermore, the company is credited with all gains from investments, but it also has to shoulder all losses that may arise. In the case of insured plans, the insurance company gives a minimum rate guarantee, thus cushioning the impact of low interest rates. However, the company should also consider the unfavorable effect of early surrenders of permanent plans.
2. Administrative expenses - As mentioned earlier, insurance companies provide services which otherwise would be provided by outside consultants, thus lowering the expenses of companies with insured plans. It should be noted that in the case of certain insured plans, the annual premium already includes all administrative expenses.
3. Tax benefits - As discussed earlier, there are three tax benefits involved:
 - a. Annual contributions to fund a retirement plan are deductible from taxable income of the company;
 - b. Investment earnings of a trust fund are not subject to tax; and
 - c. Benefits received by eligible retirees are not subject to tax.Trustee plans enjoy all three, while most insured plans qualify for benefit **a** and benefit **c** only. Moreover, for Deposit Administration plans, only amounts paid out as benefits from the DA fund are tax deductible to the company.

ACCOUNTING OF RETIREMENT BENEFIT COSTS

Introduction

In retirement benefit accounting, there are two basic concerns – the periodic cost or the expense that should be reflected in the income statement and the liability that needs to be recognized in the financial statement. Given the periodic cost for the year, the accounting could simply be:

Dr. Retirement Benefit Cost
Cr. Accrued Retirement Benefit Cost

where the Accrued Retirement Benefit Cost represents the current retirement benefit liability in the company books.

Contributions to a separate (i.e., not part of Company assets) retirement fund reduce the retirement benefit liability. When contributions are made, they are usually booked as follows:

Dr. Accrued Retirement Benefit Cost
Cr. Cash.

It then follows that if periodic costs are funded immediately, the company will have no incremental liability pertaining to its retirement program during such periods. Note that if a benefit were paid out of the retirement fund, it would not have any effect on the company books.

For defined contribution plans, the periodic cost is simply the total amount of contributions due as defined in the retirement program rules.

For defined benefit plans, however, the determination of the periodic cost is rather complicated and subject to assumptions and the relevant provisions of the accounting standards. In the Philippines, the accounting standards covering the accounting of retirement benefits is IAS 19 or PAS 19 as it is locally called. Further discussions focus on the accounting of defined benefit programs.

Funding Valuations

Basically, the periodic cost of a defined benefit retirement program is composed of the normal cost, the amortization of the past service liability and the amortization of the actuarial gains or losses. Some actuarial valuation methods, however, may not explicitly distinguish the amortization for the past service liability, the actuarial gains and losses, or both. In other words, these costs, if any, are already part of the normal cost. For example, the Entry Age Normal and Unit Credit valuation methods distinguish the three components mentioned above while the Individual Level Premium method does not explicitly recognize past service.

Different valuation methods produce different periodic costs and accrued liabilities. Given exactly the same profile of members and retirement program rules, one company's periodic cost and liability would be different under the various valuation methods. Even under the same method, the costs will vary under different assumptions.

The actuarial valuation methods, in general, are actuarial funding methods rather than accounting methods. In normal practice where actuarial valuations are performed for funding purposes, the accrued retirement benefit costs or retirement program liability recognized in the company's books are often not considered in the actuarial valuation.

Given a very broad range of possible valuation results and the other issues discussed above, the financial statement of a company would not really be reflective of the true value of the company. One company may look better than another, when in fact it is not, just because of difference in assumptions or actuarial valuation method used. The income statement may look better for a certain period over another just because no funding was made for that period or just because of a change in the valuation method or in the assumptions used in the actuarial valuation performed during that period. This is not consistent with Generally Accepted Accounting Principles (GAAP).

It is therefore necessary that actuarial valuation for funding purposes and for accounting purposes be distinguished.

Accounting Standards

Accounting and reporting standards have been developed, implemented and continuously improved. Presently, the more popular ones are the International Accounting Standards No. 19 (used by many countries especially European) and the Financial Accounting Standards No. 87 (the standard used by the U.S.). Locally, IAS 19 has been adopted effective for reporting periods beginning on or after January 1, 2005 replacing the Statement of Financial Accounting Standards No. 24 (SFAS 24) implemented in 1997 and which was actually based on IAS 19 prior to its 1998 revision.

The primary purpose of these accounting standards is to ensure a consistent determination of the amount to be recognized as expense for a given period and the amount to be recognized as a liability as of the end of that period. With this, comparability of the financial statement between companies and accounting periods will be enhanced. To achieve this, the accounting standards limit the

choice of the actuary or the company relative to the actuarial valuation methods, the assumptions and amortization of costs, among others.

The accounting standards also linked the finances of the company to the finances of the fund even if the retirement fund is a separate legal entity. Where the retirement program is under-funded, a liability should be recognized; conversely, an asset may be recognized if the program is over-funded. Of course, these are subject to certain rules.

The accounting standards normally require also the recognition of retirement benefit costs and liabilities for entities required by law to provide retirement benefits to its employees, even if there is no formal retirement program. Locally, a minimum defined benefit is mandated under Republic Act No. 7641.

Acceptable Valuation Method

Generally, the accounting standards require disclosure of the different components of the periodic retirement cost and provide distinct rules on the recognition of such costs. With this, the valuation methods that may be used have been limited to those methods that distinguish these costs separately.

Actually, IAS 19 and FAS 87 prescribe the use of only one actuarial valuation method, the Projected Unit Credit method which allocates costs relative to each period of service rendered.

Actuarial Assumptions

Recent accounting standards also define or provide guides on the choice of assumptions to be used in the valuation. As an example, IAS 19 requires that the discount rate to be used in the calculation of the present value of benefit obligation and the current service cost (the terminologies used under IAS 19 / FAS 87 to refer to the accrued liability and the normal cost, respectively) should be based on the yield of long-term corporate bonds with maturity period approximating the expected payout of benefits. Under the same accounting standards, plan assets should also be measured at fair value.

Additional Disclosure of Periodic Cost Components

Both IAS 19 and FAS 87 require disclosure of the following periodic cost components: the current service cost (normal cost), the amortization of the actuarial gains and losses, the amortization of the transition liability, the amortization of the past service cost, the interest cost on the present value of obligation (accrued liability), the expected return on plan asset, and the adjustments for curtailment. Hence, these components are determined separately in accordance with the provisions of the particular accounting standard.

A transition liability or asset arises when at the adoption of the accounting standard, the accrued liability or asset in the books of the company is not equivalent to the unfunded accrued liability or the excess fund. This balancing factor is expected to occur as new rules are implemented.

Under IAS 19, a transition asset is recognized immediately as a *prior period* adjustment or retained earnings adjustment while a transition liability may be recognized immediately or amortized up to five years.

The interest cost is the discount rate assumption applied to the present value of benefit obligation and the current service cost if such cost is computed as of the beginning of the period. This is offset by the expected return on plan assets. The net cost of these components represents the opportunity cost pertaining to the unfunded present value of benefit obligation adjusted for expected shortfall or excess of interest earnings over the discount rate.

There are two sources of actuarial gains and losses – the liability and the asset – both of which usually need to be disclosed. A loss on the liability arises when the expected accrued liability is less than the actual liability as of the valuation date. On the other hand, asset loss occurs when the expected value of the plan assets is greater than the actual value of the plan assets as of the valuation date. Actuarial gains and losses could also be due to changes in the actuarial assumptions. Usually, these gains and losses are amortized because of the expectation that in the long run, the assumptions will hold and the gains and losses will offset each other. In fact, under FAS 87, only the amortization of the excess of the gains and losses over a “corridor” may be recognized for the period. IAS 19 has a similar provision but offers an alternative option for a faster recognition of the gains and losses provided it is applied consistently.

Past service cost strictly refers to the increase in the present value of the benefit obligation due to plan amendment or plan establishment. Adjustment for curtailments may be made if there is a significant reduction in the members covered under the retirement program. The adjustment is made so that the portion of the unrecognized past service cost, unrecognized transition liability and/or unrecognized gains or losses pertaining to the separated members are recognized immediately.

Normally, under accounting standards, the amortization scheme and period for past service and transition liabilities cannot be changed once adopted. Hence a

schedule is maintained for this purpose. In contrast, actuarial gains and losses for the year are usually added to the unrecognized gains losses that are altogether re-amortized.

Proper Accounting

The periodic expense is properly accounted as follows:

Dr. Retirement Benefit Cost
Cr. Accrued Retirement Benefit Cost

It is possible that instead of liability, the financial statement would have an asset pertaining to its retirement program (*see discussion below*). In such case, the accounting entries could be:

Dr. Retirement Benefit Cost
Cr. Pre-Paid Retirement Benefit Cost

It is also possible that the current expense is greater than the asset, in such case, accounting would look like this:

Dr. Retirement Benefit Cost
Cr. Pre-Paid Retirement Benefit Cost
Cr. Accrued Retirement Benefit Cost

Instead of recognizing an expense, a company may have to recognize an income. This could happen due to any or combination of the following – exceeding the current service cost plus the interest cost plus the amortizations, if any, of the transition liability, past service cost and actuarial losses plus adjustment due to curtailment:

1. transition asset, if the transition asset is not required to be accounted as a *prior period* adjustment

2. expected return on plan assets due to the over-funded status of the plan
3. amortization of actuarial gains
4. adjustment for reduction in benefits

In such case, accounting would be:

Dr. Accrued Retirement Benefit Cost
Cr. Retirement Benefit Income

or if no liability were recognized, accounting would look like this:

Dr. Pre-Paid Retirement Benefit Cost
Cr. Retirement Benefit Income.

In the case where the liability at the beginning of the period is less than the income recognized during the period, accounting would look like this:

Dr. Accrued Retirement Benefit Cost
Dr. Pre-Paid Retirement Benefit Cost
Cr. Retirement Benefit Income.

An asset, instead of a liability, normally results under the following circumstances:

1. the plan is over-funded at the time of inception giving rise to a transition asset that is recognized immediately as a *prior period* adjustment, e.g. under IAS 19;
2. instead of an expense, income is recognized during the period and such income exceeds the liability recognized at the beginning of the period; and
/ or
3. contributions to the retirement program during the year exceed the expense recognized during the period and the liability recognized at the beginning of the period.

If the transition liability were recognized as a *prior period* adjustment, accounting would look like this:

Dr. Retained Earnings
Cr. Accrued Retirement Benefit Cost

while the transition asset is accounted as follows:

Dr. Pre-Paid Retirement Benefit Cost
Cr. Retained Earnings.

or

Dr. Accrued Retirement Benefit Cost
Cr. Retained Earnings

as the case may be.

Contributions, on the other hand, are normally accounted as follows:

Dr. Accrued Retirement Benefit Cost
Cr. Cash.

In case the contribution exceeds the cost accrual, accounting would be:

Dr. Accrued Retirement Benefit Cost
Dr. Pre-Paid Retirement Benefit Cost
Cr. Cash

Or if there is no cost accrual, then it would simply be:

Dr. Pre-Paid Retirement Benefit Cost
Cr. Cash.

Finally, benefits not paid out of the retirement plan assets should be treated as retirement fund contribution, hence, should be accounted in the same way as contributions.

Components of the Liability/Asset Recognized in the Financial Statement and their Movements

Depending on how the periodic cost is broken down and whether amortizations of costs are permitted or not, the components of the liability or asset recognized in the financial statement are tracked and are usually part of the disclosure. For example, under IAS 19, the components of this liability or asset are as follows: the present value of benefit obligation, the value of plan asset, the unrecognized transition liability, the unrecognized past service cost and the unrecognized actuarial gains and losses. Under FAS 87, because the transition asset is not recognized immediately, an unrecognized transition asset is a possible component.

The present value of the benefit obligation at the beginning of the period is expected to increase from the beginning to the end of the period by a new past service cost, the interest cost and the current service cost less the benefit payments adjusted for actuarial gains and losses. The value of plan asset would move depending on the contributions made, the benefits paid out of the fund and its actual earnings (expected earnings adjusted for any actuarial gain or loss on the asset) during the year.

The unrecognized transition liability or asset diminishes simply with the amortization during the year. The same is the true with the actuarial gains and losses except that new gains and losses normally occur during the period. Finally, the unrecognized past service cost is reduced by the amount recognized

during the year but increases by the increase in the present value of the benefit obligation due to increase in benefits made during the year.

The Balance Sheet

Accounting of retirement program costs may be summarized as follows:

R/C	1		2	3	4	5	6
1	(ACC ₀)	=	(PVBO ₀)	F ₀	UPSC ₀	UTL/(A) ₀	UAL/(G) ₀
2		=	(PSC ₁)		PSC ₁		
		=	(SC ₁)				
3	(PC ₁)		(IL ₁)	IF ₁	(APSC ₁)	(ATL)/A ₁	(AAL)/G ₁
4	C ₁	=		C ₁			
5		=	B ₁	(B ₁)			
6		=		(AL)/G ₁			AL/(G) ₁
7		=	(LL)/G ₁				LL/(G) ₁
8	(ACC ₁)	=	(PVBO ₁)	F ₁	UPSC ₁	UTL/(A) ₁	UAL/(G) ₁

where the symbols are defined as follows:

ACC : accrued retirement benefit costs or the liability (asset if positive) recognized in

the company books

PVBO : present value of benefit obligation

F : value of plan assets / fund

UPSC : unrecognized past service cost

PSC : new past service cost arising during the period

PC : periodic cost or the amount recognized as expense (income, if positive) for the period

SC : current service cost or the normal cost

IL : interest on the PVBO and the current service cost, if the current service cost is computed as of the beginning of the period

IF : expected return on the plan assets
APSC : amortization of past service cost
C : contributions to the fund
B : benefits paid from the fund
AL/(G): asset loss or gain
LL/(G) : liability loss or gain
UTL/(A) : unrecognized transition liability or asset
UAL/(G) : unrecognized gains and losses
ATL/(A) : amortization of the transition liability or asset
AAL/(G) : amortization of the gains and losses

and the subscript 0 indicates the beginning balances and the subscript 1 indicates the ending balances as well as the transactions/events during the period.

The rows present the components of the items under Column 1 while the columns illustrate the movement of each component of the liability or asset recognized in the company books.

Row 3 shows the components of the periodic pension cost. Rows 1 and 8 show the components of the liability or asset recognized in the company books - the present value of benefit obligation, the value of plan asset, the unrecognized past service costs, the actuarial gains or losses and the transition liability or asset.

In this illustration, the amount of amortization does not include interest. Interest is separately accounted for. This is in contrast to usual funding actuarial valuation where the amount of amortization already includes interest and need not be disclosed separately.

The ending liability is usually calculated using both Column 1 (movement) and Row 8 (components) to ensure consistency.

An Example

To illustrate, let us take the following example:

Company adopted IAS 19 in CY 2005, given the following:

- Present Value of Benefit Obligation (BOY) = 1000*
- Current Service Cost = 100*
- Fund = 500*
- Accrued Retirement Benefit Cost = 300*
- Discount Rate = 10%*
- Expected Rate of Return on Plan Assets = 10%*

Transaction occurring at the end of the current year:

- Benefit Payment = 200*
- Contributions to the Fund = 120*
- Present Value of Benefit Obligation (EOY) = 800*
- Fund (EOY) = 430*

First, the transition liability is calculated: $1000 - 500 - 300 = 200$. Suppose the company decides to amortize this over four years, then the annual amortization on a straight-line basis is simply 200 divided by 4 years equal to 50 .

The interest cost is $10\% \times (1000) = 100$ while the expected return on plan asset is $10\% \times (500) = 50$. Having no past service cost or actuarial gains and losses upon adoption of the standard, the periodic cost or the expense to be recognized for the year can readily be determined as follows:

<i>Current Service Cost</i>	100
<i>Interest Cost</i>	100
<i>Expected Return on Plan Asset</i>	(50)
<i>Amortization of the Transition Liability</i>	50
<i>Amortization of the Past Service Cost</i>	0
<i>Amortization of the Actuarial Gains/Losses</i>	0
	<hr/>
<i>Periodic Cost / Expense Recognized</i>	200

The liability to be recognized at the end of the period is calculated as follows:

<i>Beginning Liability</i>	300
<i>Periodic Cost / Expense Recognized</i>	200
<i>Contributions</i>	(120)
	<hr/>
<i>Ending Liability</i>	380

The accounting entries would then be:

<i>Dr. Retirement Benefit Cost</i>	200
<i>Cr. Accrued Retirement Benefit Cost</i>	200
 <i>Dr. Accrued Retirement Benefit Cost</i>	 120
<i>Cr. Cash</i>	120

or simply:

<i>Dr. Retirement Benefit Cost</i>	200
<i>Cr. Accrued Retirement Benefit Cost</i>	80
<i>Cr. Cash</i>	120

To complete the balance sheet, the gains and losses need to be determined. The expected present value of benefit obligation at the end of the period is $1000 + 10\%(1000) + 100 - 200 = 1000$. Given that the actual present value of obligation at the end of the year is 800, there's an actuarial gain on the liability of 200. On the other hand, the expected value of plan asset is $500 + 10\%(500) + 120 - 200 = 470$. The remaining fund, however, is only 430, hence, an actuarial asset loss of 40.

Filling in the values, the balance sheet would then look like this:

(300)	=	(1000)	500	0	200	0
	=	0		0		
	=	(100)				
(200)		(100)	50	0	(50)	0
120	=		120			
	=	200	(200)			
	=		(40)			40
		200				(200)
(380)	=	(800)	430	0	150	(160)

Performance of the Valuation

Valuation date should coincide with the company's accounting period that is not normally required under valuation-for-funding. Actual performance of the actuarial valuation could be prior, on or after the end of the accounting period. Most companies prefer an actuarial valuation prior to the end of the accounting period for budget purposes, but usually not earlier than three (3) months.

Assumptions on changes in the employee profile or the movements in the fund during the remaining period are made. Adjustment for actual figures as of the end of the accounting period is not really necessary. Any discrepancy may be regarded as actuarial gains and losses.

Purpose of the Valuation

The purposes of an actuarial valuation vary. It could be for accounting or funding purposes. It could be for taxation purposes or for the purpose of determining the cost of plan improvements. It could also be to determine the liability that is transferred from one company to another in case of mergers and acquisitions.

For each purpose, there are more appropriate methods and assumptions. Usually, there are more specific rules for accounting and taxation purposes giving the actuary or the company less latitude in the choice of method and assumptions. In determining the cost of benefits or the retirement program liability in merger and acquisition cases, the actuary has a broad choice of methods and assumptions but constrained with what are acceptable to the parties involved. For purposes of funding, the company normally decides how to fund the retirement program and therefore, the valuation method follows accordingly unless otherwise statutes require minimum funding, in which case, acceptable valuation methods and assumptions may be narrowed down as the funded status of the program needs to be measured.

Some companies regularly perform two actuarial valuations – one for accounting purposes and another for funding purposes with the latter adhering to the company's funding policy. Others just use the results of the actuarial valuation for accounting as the basis for their funding.

Finally, accounting standards constantly change. Normally the changes would revolve around how expense is recognized, the required disclosures, the actuarial valuation method and the choice of actuarial assumptions. The basic accounting principle, the same thing as the basic actuarial principles, however, would remain the same. The key to understanding these standards is an in-depth knowledge of the balance sheet as presented herein. Given the knowledge, reconstruction of the balance sheet in accordance with new accounting standards should not be difficult.