First-time adoption of International Accounting Standards for EOS benefits

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In many countries in the Middle East it is a legal obligation to provide an end of service (EOS) severance benefit when an employee leaves an employer. Analysis by Milliman indicates that a significant proportion of companies could be underreporting when accounting for the cost of these benefits. We explore this issue in further detail within this article.

FRAMEWORK FOR ACCOUNTING FOR EOS BENEFITS

EOS benefits may be payable when an employee leaves employment at some date in the future. The company should make an allowance within its accounts for these expected future costs. The amounts involved can be considerable.

In the past, these costs have often been estimated based on the accrued benefit entitlements for the active employees, i.e., the benefits that would be payable if all employees were to leave at the company's year-end.

However, in recent years there has been an increasing trend toward accounting for these benefits under International Accounting Standards (IAS). These standards (and in particular the guidance relating to accounting for employee benefit costs, IAS 19) provide a framework for the transparent representation of the long-term costs. Aside from the advantages of this for internal management purposes, it can aid consistent reporting within a multinational firm and enable better comparisons between global competitors. It also helps meet regulatory requirements where capital is raised and traded on foreign exchanges.

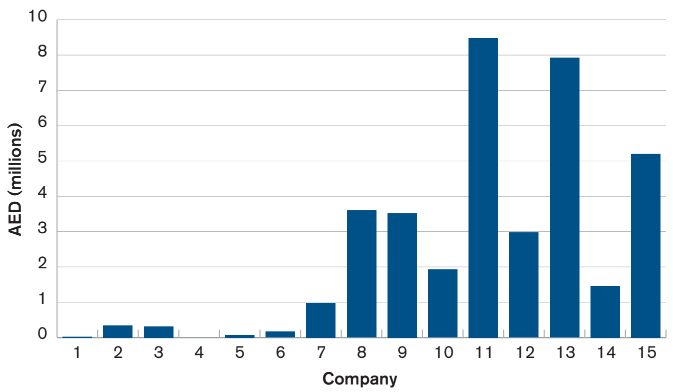
The actual cost of the EOS benefits is the payment eventually made when an employee leaves employment (based on salary and service at that time). This amount does not change by introducing international reporting processes; rather, they represent a way to apportion the cost to different periods of time.

IMPACT ON RESERVES BY ADOPTING INTERNATIONAL STANDARDS

We have carried out analysis of 15 representative companies from our client base in the Middle East. It shows that when companies move to using international standards there is typically a rise in the required reserves.

The chart in Figure 1 shows the impact on the reserves for the companies studied. The companies are ranked by the size of liability prior to adoption of international standards.

FIGURE 1: ADDITIONAL LIABILITIES USING IAS 19



METHOD FOR DETERMINING THE RESERVES UNDER INTERNATIONAL STANDARDS

The current accrued benefit is the starting point in making the cost estimations under IAS 19. From here, adjustments are made in regard to the following factors:

- Increases to salary over time, up to the point of the employee's exit from the company.
- Resignation/retirement timing, to build a picture of when the payments will be due.
- The change in the applicable 'vesting' reduction factor over time. For example, under United Arab Emirates (UAE) Labour Law, the benefit is scaled back if an employee leaves a company prior to completion of five years' service.
- Changes in the rate at which benefits are earned. For example, under UAE Labour Law, the annual level of accrual rate rises from 21 to 30 days a year after five years' service.
- Any enhancement granted to statutory benefits.
- The rate of interest for determining the present value of the expected payments.

Based on the above factors, we can estimate the expected future payments to employees. These projected payments are discounted with bond yields to get a present value at the company's year-end. This analysis can give insights into the pattern and amount of future cash-flow needs for the company, and how they might vary under different scenarios.

It is important that realistic assumptions are set to take account of the above factors. They will vary according to a company's plans, industry and location.

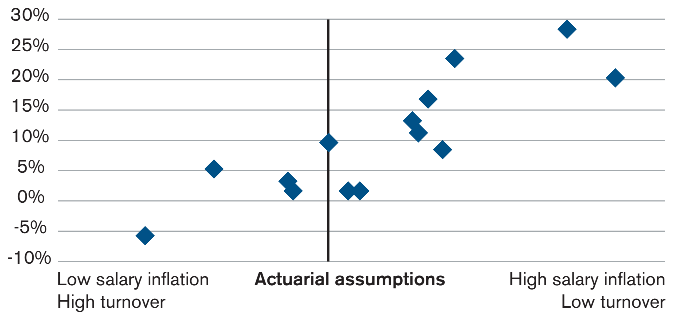
WHAT WOULD THE IMPACT BE FOR YOUR COMPANY?

The impact of moving to international standards will depend on how reserves were established previously. If previously the reserves were determined on an accrued benefit approach, there are likely to be two key factors at play that lead to a higher reserve under the IAS 19 approach:

- **Salary escalation**: This effect is offset by a requirement to apply a discounting factor based on high-quality bond yields. However, the net effect is still typically a higher reserve.
- **Rising cost of accrual:** The example in the sidebar shows how the costs increase rapidly under UAE Labour Law with an employee's service. Under international standards, there is allowance for this known increase to future costs.

The chart in Figure 2 shows the impact on the reserves for the companies studied. We have plotted the increases in reserves against a combination of the underlying salary inflation and resignation assumptions for each company. This demonstrates the correlation of the impact of adopting the accounting standard and the relative salary or resignation assumptions.

FIGURE 2: % INCREASE IN RESERVES



EXAMPLE EOS BENEFIT CALCULATIONS

An employee of XYZ Co. earns AED10,000 a month and joined the company two years ago. On leaving XYZ Co. a benefit of 21 days of salary is provided for each year of service. The service credited is 0% of the employee's time at the company if he or she joined less than one year ago, 33% for one to three years, 67% for three to five years and 100% for more than five years. The employee's monthly salary is expected to increase by AED500 a year.

If the employee leaves today the EOS benefit will be:

10,000 x 2 x 33% x (21/30) = 4,620

If the employee leaves in three years the EOS benefit is estimated as:

(10,000 + 500 x 3) x 5 x 100% x (21/30) – 40,250

For all service above five years, a benefit of 30 days of salary is provided for each year of service.

So the actual cost can rise steeply over the short term. It depends heavily on how long the employee stays at the company and how much his or her salary increases over that time.

HERE ARE SOME QUESTIONS TO CONSIDER:

- Do you understand what your financial obligations are in respect of your EOS benefits and how they will vary over time?
- Do you factor this into your forward planning?
- Do your accounting disclosures fit with the rest of your organization and industry best practice?

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