5. Other Components of Employee Compensation

Paid vacations are another element of compensation that many employees receive. In addition to paid vacations, employers may provide for other periods of "compensated absences." Examples include paid sick leave, holidays, family emergency time, "comp time" (payback for working overtime), birthdays, jury duty time, military reserve time, and so forth. Sometimes, these benefits accumulate with the passage of time, so that the benefit is a function of tenure with the company. To illustrate, a company may stipulate that one half-day of sick leave and one day of vacation time is accrued for each month of employment.

Because the cost of periods of compensated absence can become quite significant, it is imperative that such amounts be correctly measured and reported. Accounting rules provide that companies expense (debit) and provide a liability (credit) for such accumulated costs when specified conditions are present. Those conditions are that the accumulated benefit (1) relates to services already rendered, (2) is a right that vests or accumulates, (3) is probable to be paid to the employee, and (4) can be reasonably estimated (note that the last two conditions -- probable and reasonably estimable – are purloined from the contingency rules discussed earlier). Vacation pay typically meets these conditions for accrual, while other costs may or may not depending upon the individual company's policies and history. The bottom line here, is that a company will expense the cost of periods of compensated absence as those benefits are earned by the employee (another example of the matching principle); when the employee receives their pay during their time off, the attendant liability will then be reduced.

5.1 Pension Plans

It is common for a company to offer some form of retirement plan for its employees. These were touched upon in the above illustrated entries. But, more needs to be said about such plans. First, I must point out that this is a very complex area of accounting. Most intermediate textbooks will devote a full chapter to this subject alone, and reducing the discussion to a few paragraphs is a daunting challenge for any author. Let me begin by noting that there are two broad types of pensions -- defined contribution plans and defined benefit plans.

With a defined contribution plan, an employer promises to make a periodic contribution (usually a set percentage of the employee's salary with some matching portion also put up by the employee) into a separate pension fund account. After a minimum vesting period, the funds become the property of the employee for their benefit once they enter retirement. Prior to withdrawal, the funds might be invested in stocks, bonds, or other approved investments. The employee will receive the full benefit of the funds and the investment returns, usually withdrawing them gradually after retirement. With defined contribution type plans, there will be winners and losers. If such funds are invested well for long periods, they can grow to substantial sums and employees can enjoy great retirement benefits. On the other hand, some persons will be disappointed when the investment performance of their fund fails to meet target performance standards.

For the employer, defined contribution plans offer an important desirable feature: the employer's obligation is known and fixed. Risk is transferred to the employee. Further, the employer ordinarily gets a tax deduction for its contribution, even though the employee does not recognize that contribution as taxable income until amounts are withdrawn from the pension many years later. Another aspect of defined benefit plans is that the accounting is straight-forward. The company merely expenses the required periodic contribution as incurred. Thus the company expenses the retirement plan payment (like in the journal entries above), and no further accounting on the corporate books is necessitated. The pension assets and obligations are effectively transferred to a separate pension trust, greatly simplifying the recordkeeping of the employer.

In stark contrast are the defined benefit plans. With these plans the employer's promise becomes more elaborate, and its cost far more uncertain. For example, the company may agree to make annual pension payments equal to 2% (for each year of service) times the average annual salary during the last three years of employment. So, a person who works 30 years and then retires, may be eligible for continuing pay at 60% of their average salary during the last years of employment. Obviously, these plans are fraught with uncertainty. How long will retirees live and draw benefits, how many years will employees work, how much will their salary be, and so on?

Accountants typically rely on actuaries (persons trained and skilled to make assessments about life expectancy and related work force trends) to come up with certain core estimates. Then, those estimates are leveraged into an elaborate accounting model that attempts to produce an estimated annual expense for the eventual pension cost. Some or all of that estimate is funded each year by a transfer of money into a pension trust fund. Those funds are invested and eventually disbursed to retirees, but the company remains obligated for any shortfalls in the pension trust.

On the corporate books, you will find the amount of expense attributed to each year (remember, this amount is only an estimate of actual cost since the true cost will not be known for many years to come). Beyond that, if a company has failed to fund all the amounts expensed to date, or if the pension fund is "underfunded" relative to outstanding pension promises made, a pension liability is reported on its balance sheet. But, the bulk of the pension assets and obligations are carried on the books of the separate pension trust fund.

There has been a clear trend in recent years away from defined benefit plans and toward defined contribution plans. Contributing factors have been to reduce corporate risk, simplify corporate accounting, provide benefits more suitable for transitory work forces, and satisfy workers who perceive that their own investment returns generated via defined contribution plans will produce a better retirement.

5.2 Other Post Retirement Benefits

Some companies provide items like health care coverage, prescriptions, and life insurance. It is not uncommon for an employee to continue to enjoy such benefits after retirement. However, because the employee is no longer working for the company, it is imperative that corporate cost of such benefits be expensed during the period of time during which the employee is actively working for the company and helping it to produce revenues. Again, the matching idea comes into play, where we must expense costs to match the revenue they help to produce. As a result, companies will expense the estimated cost of post retirement benefits over many years, creating an offsetting liability. In later years, as the cost of post retirement benefits is paid out, the liability is accordingly reduced. (Note: as with pensions, portions of the liability may appear in the current liability section of the balance sheet, and portions in the long-term section).