IMPLEMENTING IPSAS: A GUIDE FOR TRAINERS

Liabilities

2024 Edition

Contents

General

Liabilities

The Handbook of International Public Sector Accounting Pronouncements is the primary authoritative source of international generally accepted accounting standards for public sector entities.

This module focuses on the requirements for reporting provisions and contingent liabilities in IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets* as well as IPSAS 39, *Employee Benefits*.

Liabilities that meet the definition of financial instruments such as bank borrowings and other short term and long term debt, are financial instruments in IPSAS 28, *Financial Instruments: Presentation*, IPSAS 29, *Financial Instruments: Recognition and Measurement* / IPSAS 41, *Financial Instruments* and IPSAS 30, *Financial Instruments: Disclosures* and are covered separately in the Financial Instruments module.

Lease liabilities are covered separately in the Assets module.

Typical Liabilities

- Accounts payable and accrued expenses
- Provisions
- Pensions and other employee benefits
- Unearned revenues
- Transfer expenses payable
- Social benefit liabilities.

A public sector entity is likely to have at least some of the following types of liabilities:

a) Accounts payable arising from the purchases of goods and services;

b) Accrued salaries and wages;

c) Accrued vested vacation pay or other accrued compensated absences;

d) Provisions for employee pension obligations and other accrued employee benefits, including any accrued termination benefits;

e) Provisions for amounts payable under guarantees and indemnities (where sufficient evidence is available to indicate that it is more likely than not that the amounts will be payable);

f) Liabilities relating to unearned revenues;

g) Transfer expenses payable;

h) Social benefits liabilities

i) Provisions for environmental liabilities; and

j) Obligations under accident compensation schemes.

Obligations are central to the concept of a liability. Obligations result in a public sector entity being bound or committed to a particular course of action. Public sector entity liabilities arise from many different types of obligations. They can arise from:

a) agreements or contracts;

b) legislation; or

c) constructive obligations, meaning they can be inferred from the facts in a particular situation.

The most common type of obligation is a legal obligation.

Not all obligations result in a recognition of a liability at the reporting date. Only those obligations that meet the definition of a liability are reported in the financial statements of public sector entities.

At a whole-of-government level, debt and borrowings and unfunded pension liabilities and other post-employment benefits are likely to be the most significant non-current liabilities. Within individual public sector entities, employee-related liabilities and provisions may be the most significant non-current liabilities. Some public sector entities may also have liabilities under finance leases.

Liability Definition

A **liability** is a present obligation of the entity for an outflow of resources that results from a past event.

•A **present obligation** is binding. To satisfy the definition of a liability, it is necessary that a present obligation arises as a result of one or more past transactions or other past events and has the potential to require the entity to transfer resources from the entity.

An entity has a present obligation (legal or constructive) as a result of a past event. An obligating event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

Note that while the *Conceptual Framework* refers to an entity transferring resources, individual IPSAS< for example IPSAS 19, may still refer to an outflow of resources.

A constructive obligation (referred to in the Conceptual Framework as a non-legally binding obligation) generally results when an event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation. For example, a government, by established past practice, published policies, or a sufficiently specific current statement, has created a valid expectation on the part of other third parties that it assume responsibility for cleanup of a contaminated site. The government's own actions or conduct has resulted in the loss of discretion to avoid settlement of its obligation.

The occurrence of an obligating event on or before the financial statement date distinguishes a present obligation from a future obligation. The past transaction or event eliminates any uncertainty that transactions or other events expected to occur in the future do not, in themselves, give rise to present obligations. It makes it explicit that the event giving rise to the entity's obligation has already occurred.

An obligation always involves another party to whom the obligation is owed. The liability is the entity's if it embodies a duty or responsibility to others to a future transfer or use of assets, provision of goods or services, or other form of economic settlement. It is not necessary, however, to know the identity of the party to whom the obligation is owed — indeed the obligation may be to the public at large. For example, a government may have an environmental liability without knowing the identity of the contractor who will be hired to carry out the work.

Because an obligation always involves a commitment to another party, it follows that a decision by an entity's management, governing body, or controlling entity does not give rise to a liability at the reporting date.

For example, a government has a policy to maintain its roads at a specified standard of condition. However, until services are performed by others to maintain the road's condition, the entity has no obligation to an external party and, therefore, there cannot be a liability.

Decisions such as budgeting for purchases or transfers and future program expenditures are not present obligations. In these circumstances an entity is not bound to a particular course of action, as it has realistic alternatives to change or avoid the obligation through its own actions. For example, an entity may budget for the purchase of a fire truck and commitments for future ongoing program expenditures. These are possible future obligations that a government can avoid through its own actions. The entity is not bound to a particular course of action. It has the discretion to change or avoid the possible future obligation through its own actions.

Liabilities are present obligations with the potential to result in a transfer of resources embodying economic benefits or service potential. The fact that there is uncertainty about the timing or amount of the future expenditure required in settlement of a liability does not affect the recognition of a liability. This type uncertainty may be taken into account in the measurement of the liability.

Having the potential to result in a transfer means that there is some, but not necessarily a high, expectation of future transfers by the entity. This does not imply that a particular threshold level such as probable or virtually certain needs to be met but simply that there must be some expectation of future transfers. Individual IPSAS may, however, specify a threshold that must be met before certain items can be recognized in the financial statements.

Settlement of an obligation may be done in a variety of ways. It may be the transfer or use of cash or other assets, the provision of goods or services, the incurrence of another liability or some other form of economic settlement. Some liabilities such as for employee future benefits may not be due for settlement until well after the fiscal period end in which they are reported. However, in most cases, an entity will not have an unconditional right to defer settlement of a liability indefinitely.

Liability Recognition Criteria

An item that meets the definition of a liability should be recognized if

a) It is probable that there will be an outflow of service potential or economic benefits from the entity

b) The item has a cost or fair value that can be measured with reliably.

These criteria apply to most liabilities, although individual IPSAS specify the recognition criteria for specific types of liability. Where a transaction is not covered by an IPSAS, an obligation that meets the definition of a liability but does not one or both of the other criteria would meet the definition of a contingent liability in IPSAS 19. Individual IPSAS may specify a different probability threshold for recognition, or deal with this when measuring the item, in line with the *Conceptual Framework*.

The recognition criteria are similar to the recognition criteria for assets and provide general guidance on when an item is recognized in the financial statements. Whether any particular item is recognized or not will require the exercise of professional judgment in considering materiality and whether the specific circumstances meet the recognition criteria.

An outflow of resources or other event is regarded as probable if the event is more likely than not to occur, that is, the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits or service potential is remote.

The general recognition criteria require that an item has an appropriate basis of measurement, and a reasonable estimate can be made of the amount involved. For liabilities incurred, the transactions are generally initially recognized in financial statements at the amount of cash or cash equivalents to be paid or the fair value ascribed to the liability when incurred if it is a non-monetary transaction.

Except in extremely rare cases, an entity will be able to determine a range of possible outcomes, and can therefore make an estimate of the obligation that is sufficiently reliable to use in the preparation of financial statements.

Recognition does not mean disclosure in the notes to the financial statements. Notes either provide further details about items recognized in the financial statements, or provide information about items that do not meet the criteria for recognition and thus are not recognized in the financial statements.

When a reasonable estimate cannot be made, the item is not recognized in the financial statements. For example, the expected outcome of a lawsuit may meet the definition of a liability as well as the probability criterion for recognition; however, if it is not possible for the obligation to be measured reliably, it would not be recognized as liability. Disclosure in notes as a contingent liability may be appropriate.

Illustrative Example

An entity has a reporting date of March 31

1. It received 10 trucks on March 15, with payment of CU 500,000 due in thirty days.
2. It has outstanding purchase orders totaling CU 100,000 for materials and supplies not yet received.
3. It has contracted with an external auditor for audit services related to the reporting period just ended.

Question:

In each case, does the entity report an account payable or accrued expense at the reporting date? If yes, what is the classification?

Explain the rationale of your answers.

Answers:

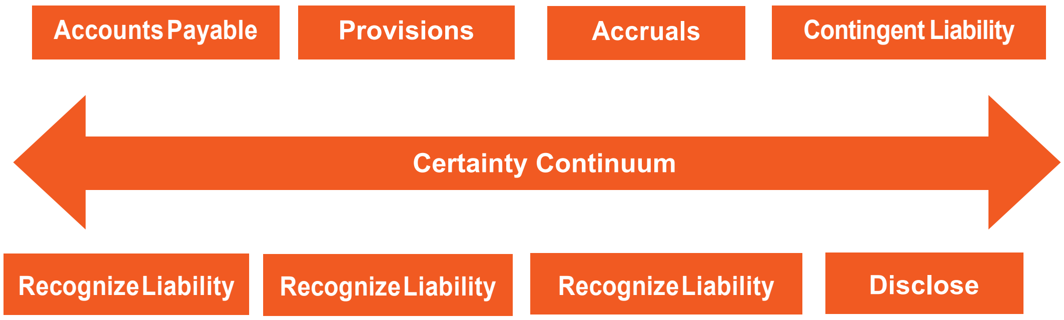
Scenario 1 - The entity reports an account payable on its statement of financial position for the purchase of the trucks even though payment is not due at the period end. The amount has formally been agreed with the supplier. There is no uncertainty as to either the amount or the timing of settlement.

Scenario 2 - An entity has a reporting date of March 31. The entity does not report an account payable or accrued expense for the amount of the outstanding purchase orders. Liabilities only result from a past event, that is, the receipt of materials and supplies. Outstanding purchase orders do meet the definition of a liability until delivery occurs.

Scenario 3 - The entity will generally report an accrued expense on its statement of financial position for the estimated fees for audit services. The audit services relate to the prior period even though they are rendered in the subsequent fiscal period. The requirement to have financial statements may be legislative. The past event that creates the liability is the end of the fiscal period. The services have been agreed with the supplier and relate to the fiscal period. Even though the exact amount of the fees is unknown, they can be reasonably estimated. There is little uncertainty related to timing of settlement. It is often necessary to estimate the amount or timing of the settlement of accrued expenses.

Provisions - Definitions and Recognition

- Provisions – liabilities of uncertain timing or amount
- Contingent liabilities – possible obligations to be confirmed by occurrence of future events.



Provisions can be distinguished from other liabilities such as payables and accruals because there is uncertainty about the timing or amount of the future expenditure required in settlement.

Payables are liabilities to pay for goods or services that have been received or supplied, and have been invoiced or formally agreed with the supplier.

Accruals are liabilities to pay for goods or services that have been received or supplied, but have not been paid, invoiced, or formally agreed with the supplier, including amounts due to employees (for example, amounts relating to accrued vacation pay). Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions.

Accruals are often reported as part of accounts payable, whereas provisions are reported separately.

A provision is recognized when:

a) An entity has a present obligation (legal or constructive) as a result of a past event;

b) It is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation; and

c) A reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognized.

In most cases, such as an account payable or a loan, it will be clear that a past event has given rise to a present obligation. In some cases it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the reporting date.

In other cases, for example in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such cases, an entity determines whether a present obligation exists at the reporting date by taking account of all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the reporting date.

On the basis of the evidence:

- **a)** Where it is more likely than not that a present obligation exists at the reporting date, the entity recognizes a provision (if the recognition criteria are met); and
- **b)** Where it is more likely that no present obligation exists at the reporting date, the entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits or service potential is remote (see discussion under contingent liabilities).

Where there are a number of similar obligations, the probability is determined by considering the class of obligations as a whole.

Although the likelihood of outflow for any one item may be small, it may be probable that some outflow of resources will be needed to settle the class of obligations as a whole. In this case, a provision is recognized (if the other recognition criteria are met).

For example, a municipality may anticipate multiple damage claims from property owners resulting from the failure of a storm water system. Each potential claim is individually insignificant, however, from past experience, as a class the claims could be material. The municipality would assess the probability of an outflow of resources based on the class as a whole. A liability would be recognized if reliably measurable.

Another example would be a government's obligation to compensate individuals who have received contaminated blood from a government-owned hospital. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. The probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. If it is probable that an outflow will occur for the class as a whole, if it can be measured reliably, a liability is recognized.

A contingent liability is a possible obligation that arises from past events, and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

In a general sense, all provisions are contingent because they are uncertain in timing or amount. However, provisions are different from contingent liabilities. The term contingent is used for liabilities that are not recognized because they are possible obligations at the reporting date. Their existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

In addition, a contingent liability may also be a present obligation that arises from past events, but is not recognized because it does not satisfy the recognition criteria. That is, it is not probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation.

When an entity determines it is not probable that an outflow due to an obligation will occur, the entity does not recognize a liability. Instead it discloses a contingent liability unless the possibility of an outflow of resources embodying economic benefits or service potential is remote. If the entity determines, based on an assessment of available evidence, that the possibility of an outflow of resources is remote, it does not disclose the possible obligation.

Contingent liabilities are assessed continually to determine whether an outflow of resources becomes probable. If it becomes probable that an outflow of resources will be required for an item previously dealt with as a contingent liability, a provision is recognized in the financial statements of the period in which the change in probability occurs provided a reliable estimate can be made of the amount. For example, a local government entity may have breached an environmental law, but it remains unclear whether any damage was caused to the environment. When, subsequently it becomes clear that damage was caused and remediation will be required, the entity would recognize a provision because an outflow of economic benefits is now probable.

Similarly, in the extremely rare case when the amount of the obligation cannot be measured with sufficient reliability, a liability exists that cannot be recognized. The entity would disclose a contingent liability.

The preparation of financial statements requires the use of reasonable estimates and this does not undermine their reliability. There is a degree of uncertainty associated with the measurement of many amounts recognized or disclosed in the financial statements. Just because an estimate is involved does not mean that an item does not meet the criteria for recognition. Except in extremely rare cases, an entity will be able to determine a range of possible outcomes, and can therefore make an estimate of the obligation that is sufficiently reliable to use in the preparation of financial statements.

Illustrative Example

Scenario

A public sector entity operates a nuclear power generation plant. Storage of spent fuel cells complies with legislation. New legislation to be enacted after the reporting date will retroactively change the standards. If enacted, the entity will have to make significant expenditures on storage of spent fuel cells generated from past operations.

Should the entity recognize a provision or disclose a contingent liability at the reporting date? Explain.

Answer:

An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law. In this case, there is no obligation at the reporting date to change the methods used to store spent fuel cells generated from past operations. The requirement to change storage methods will be an obligating event when the new law requires the existing storage methods to be changed even though it may have retroactive effect.

Where details of a proposed new law have yet to be finalized, an obligation arises only when the legislation is virtually certain to be enacted as drafted. However, differences in circumstances surrounding enactment often make it impossible to specify a single event that would make the enactment of a law virtually certain. In many cases, it is not possible to judge whether a proposed new law is virtually certain to be enacted as drafted, and any decision about the existence of an obligation should await the enactment of the proposed law.

A contingent liability is a possible obligation that arises from past events. In this case the future enactment of legislation is not a past event. The entity would not disclose a contingent liability. It may disclose information in notes about the impending legislative change and the financial effect it may have on the entity.

Illustrative Example

Scenario

At the reporting date legal proceedings have been commenced seeking property and punitive damages from a municipality for injuries suffered in an automobile accident. The suit alleges the municipality had a responsibility to maintain the road and that it was negligent in fulfillment of that responsibility. Legal counsel for the local government advises there is a 30% probability that it will be liable.

a) Should the entity recognize a provision or disclose a contingent liability? Explain.

b) Does the answer change if in a subsequent period the probability is (i) remote or (ii) 60%? Explain.

Answer:

a) A provision is a liability of uncertain timing or amount. At the reporting date, the municipality does not have a present obligation as a result of a past event. The existence or non-existence of a present obligation will be determined by the future finding of the court. When an entity determines it is not probable that an outflow due to an obligation will occur, the entity shall not recognize a liability.

On the basis of the evidence available, there is a possible obligation. Whether a present obligation exists will be determined by the decision of the court regarding whether or not the local government was negligent in fulfilling its responsibilities for the maintenance of the road and whether that contributed to the accident. The occurrence or non-occurrence of the event is not within the control of the local government. Based on the advice of legal counsel, an outflow of resources in settlement is not probable.

The municipality has taken account of all available evidence including the opinion of experts. There is no additional evidence provided by events after the reporting date. It has determined that it is not probable (it is more likely that no present obligation exists at the reporting date). The probability that a possible obligation exists at the reporting date is not remote. The local government discloses a contingent liability.

b) The contingent liability is continually assessed to determine whether an outflow of resources has become probable. When it is assessed as remote that the local government will be liable, it does not disclose a contingent liability.

When it is probable that an outflow of resources will be required (that is, it is more likely than not that a present obligation exists at the reporting date) for an item previously dealt with as a contingent liability, a provision is recognized in the financial statements of the period in which the change in probability occurs provided a reliable estimate can be made of the amount.

Measurement of Provisions

- Amount recognized is best estimate of the expenditure required to settle the present obligation at the reporting date
- Best estimate is the amount an entity would rationally pay to settle the obligation or to transfer it to a third party at reporting date
- Uncertainty is dealt with by various methods
  - Expected value
  - Individual most likely outcome.

It will often be impossible or prohibitively expensive to settle or transfer an obligation at the reporting date. However, the estimate of the amount that an entity would rationally pay to settle or transfer the obligation gives the best estimate of the expenditure required to settle the present obligation at the reporting date.

Estimates require the exercise of judgment by management supplemented by experience and, in some cases, reports from independent experts. The estimates of outcome and financial effect are determined by the judgment of the management of the entity, supplemented by experience of similar transactions and, in some cases, reports from independent experts. Any additional evidence provided by events after the reporting date is considered.

Uncertainties surrounding an estimate are dealt with by various means according to the circumstances.

The risks and uncertainties that inevitably surround many events and circumstances are taken into account in reaching the best estimate of a provision. Risk describes variability of outcome. A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgments under conditions of uncertainty, so that revenue or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.

Where the provision being measured involves a large population of items, the obligation is estimated using the statistical method of estimation "expected value." Under this method, the possible outcomes are weighted by their associated probabilities. Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the midpoint of the range is used.

Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. However, the entity considers other possible outcomes.

Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount.

Illustrative Example

Scenario

A government has a legal obligation to remediate a contaminated site. A site assessment has determined two options. The most likely outcome is containment. There is a chance that contamination will have to be removed and treated. Possible outcomes are in the table.

	Estimate	Probability
Option A - Containment	CU 2 million	70%
Option B - Removal	CU 10 million	30%

What is the amount of the provision? Explain

Answer:

An expected value approach is appropriate for estimating a provision for a large population of items. In contrast, IPSAS 19 specifies that 'the individual most likely outcome may be the best estimate of ' a single obligation. However, the entity considers other possible outcomes. Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount.

Measuring a liability at the 'most likely outcome' may conflict with the principle of measuring liabilities at the 'amount that an entity would rationally pay to settle the obligation or to transfer it to a third party'. The determination of the amount an entity would rationally pay to settle an obligation or to transfer it to a third party would take into consideration the risks of other potential outcomes. Therefore, measuring the liability at its most likely outcome fails to reflect the uncertainty inherent in the obligation.

If the individual most likely outcome is used in all cases, it could result in two obligations with different risks and uncertainties being measured at the same amount. An expected value approach may also be appropriate for single obligations.

In this case, the individual most likely outcome is that containment is successful at a cost of CU 2 million.

However there is a significant chance that the possible outcome is higher than the most likely outcome. The best estimate will be a higher amount.

The provision is measured as follows:

(CU 2 million * 70%)+(CU 10 million *30%)= CU 4.4 million.

Present Value

- Estimate based on the present value when time value of money is material
- The discount rate used reflects
  - Current market assessments
  - Risks specific to the liability
- Does *not* reflect risks for which future cash flow estimates adjusted
- Increase in PV due to passage of time is recognized as an interest expense.

Because of the time value of money, provisions relating to cash outflows that arise soon after the reporting date are more onerous than those where cash outflows of the same amount arise later. Provisions are therefore discounted, where the effect is material.

The discount rate (or rates) used is a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability.

The discount rate does not reflect risks for which future cash flow estimates have been adjusted.

Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognized as an interest expense.

When a provision is discounted over a number of years, the present value of the provision will increase each year as the provision comes closer to the expected time of settlement.

In some jurisdictions, income taxes or income tax equivalents are levied on a public sector entity's surplus for the period. Where such income taxes are levied on public sector entities, the discount rate selected should be a pre-tax rate.

Future Events

- The estimate of the provision should reflect expected future events
- Future events may be
  - Inflation
  - Changes in technology
  - Cost reductions due to experience
  - New legislation

Future events that may affect the amount required to settle an obligation will be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

Future events may be:

- the effects of inflation or other specific price changes
- future changes in technology available at the time of the settlement
- cost reductions associated with increased experience
- effects of new legislation when virtually certain to be enacted

If there is sufficient evidence of likely expected rates of inflation, this is reflected in the amount of the provision.

When a government believes that the cost of cleaning up contamination will be reduced by future changes in technology, the amount recognized reflects the cost that technically qualified, objective observers reasonably expect to be incurred, taking account of all available evidence as to the technology that will be available at the time of the clean-up. However, an entity does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

It is appropriate to include expected cost reductions associated with increased experience in applying existing technology, or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out.

The effect of possible new legislation that may affect the amount of an existing obligation of a government or an individual public sector entity is taken into consideration in measuring that obligation, when sufficient objective evidence exists that the legislation is virtually certain to be enacted. Generally, the impact of new legislation is not considered until the new legislation is enacted.

Other Measurement Issues

- Gains from disposal of assets not considered in estimate of provision
- Reimbursements by another party
    - A separate asset (not offset against liability)
    - Not to exceed provision
    - Expense may be presented net

Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an entity recognizes gains on expected disposals of assets at the time specified by the IPSAS dealing with the assets concerned. For example, the derecognition requirements of IPSAS 44, *Non-current Assets Held for Sale and Discontinued Operations*, IPSAS 45, *Property, Plant, and Equipment* or IPSAS 31, *Intangible Assets* may be applicable.

Sometimes, an entity is able to look to another party to pay part or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses, or suppliers' warranties). Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement is recognized when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation.

- The reimbursement is treated as a separate asset
- The reimbursement should not exceed the provision
- The expense may be presented net of the amount recognized for a reimbursement

The reimbursement is treated as a separate asset in the statement of financial position. In most cases, the entity will remain liable for the whole of the amount in question, so that the entity would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognized for the full amount of the liability, and a separate asset for the expected reimbursement is recognized when it is virtually certain that reimbursement will be received if the entity settles the liability.

The amount recognized for the reimbursement should not exceed the amount of the provision.

In the statement of financial performance, the expense relating to a provision may be presented net of the amount recognized for a reimbursement.

The other party may either reimburse amounts paid by the entity, or pay the amounts directly. For example, a government agency may have legal liability to an individual as a result of misleading advice provided by its employees. However, the agency may be able to recover some of the expenditure from professional indemnity insurance.

In some cases, the entity will not be liable for the costs in question if the third party fails to pay. In such a case, the entity has no liability for those costs, and they are not included in the provision.

An obligation for which an entity is jointly and severally liable is a contingent liability, to the extent that it is expected that the obligation will be settled by the other parties.

Changes in Provisions

- Provisions reviewed at each reporting date
    - Adjusted to reflect current best estimate
    - Reversed if not probable settlement required
- Change in provision is change in estimate made prospectively (current year result)

Provisions are reviewed at each reporting date, and adjusted to reflect the current best estimate.

If it is no longer probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation, the provision is reversed.

Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognized as an interest expense.

A provision is used only for expenditures for which the provision was originally recognized.

'Use' of a provision involves charging expenditures against a provision. Only expenditures that relate to the original provision are set against it. Setting expenditures against a provision that was originally recognized for another purpose would conceal the impact of two different events.

Illustrative Example

Scenario

On January 1, 20X0, an entity puts a nuclear power generation plant in service at cost CU 100 million. There is a legal obligation for decommissioning the plant at the end of its useful life and ongoing management of contaminated material from operations. The plant is depreciated over 40 years on straight line basis.

a) Should the entity recognize a provision? Why or why not?

b) If yes, what should the basis of measurement be? Why?

Answer:

a) The entity has a present obligation to decommission (demolition, site remediation, etc.) the plant and manage the contaminated waste material. The past event that created the obligation was the acquisition, development, or construction of the nuclear plant. It is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation.

b) In this case, the amount recognized as a provision is the best estimate of the expenditure required to decommission the plant and manage the waste material from ongoing operations at the reporting date. The best estimate is the amount an entity would rationally pay to settle the obligation at the reporting date or transfer it to a third party at that time.

Prices quoted in an active market would provide the most reliable indication of the best estimate of the expenditure required to settle the present obligation. If there is no active market, an entity establishes fair value by using a valuation technique. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal operating considerations.

Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties for obligations that are similar in nature, if available.

The chosen valuation technique makes maximum use of market inputs and relies as little as possible on entity- specific inputs. It incorporates all factors that market participants would consider in arriving at the best estimate. The risks and uncertainties are taken into account when determining the best estimate of the provision. Due to the unique risks regarding both amount and timing of settlement associated with environmental liabilities, expected value is likely to be the valuation technique most commonly used. The obligation is estimated by weighing all possible outcomes by their associated probabilities. This approach is based on estimates of future cash flows required to settle an obligation.

Risks and uncertainty associated with the amount and timing of settlement are taken into account in weighing the probability of outcomes. In this case, the effect of the time value of money is material. The amount of the provision will be the present value of the expenditures expected to be required to settle the obligation.

Measuring a liability on this basis involves the use of the cost of fulfillment measurement basis. Further details of this basis can be found in *IPSAS 46, Measurement*, which is covered in Module 10.

Estimates

Activity	Estimated cash flows (not discounted) (000's CU)	NPV Dec 31, 20X1* (000's CU)	NPV Dec 31, 20X0 (000's CU)	NPV Jan 1, 20X0 (000's CU)
Decommissioning	25,000	2,731	2,576	2,430
Waste Management	92,941	3,518	3,319	3,131
Total	117,941	6,249	5,895	5,561
*** Discount rate 6%. A review at end of 20X1resulted in no material changes.**				

Scenario - Assume the same fact situation as in previous example. The table below provides estimated cash flows required to settle the obligations. A discount rate of 6% has been used. Estimates were reviewed at the period end December 31, 20X1 and no material changes were necessary.

a) What is the amount of the provision at December 31, 20X0 and 20X1?

b) What is the original cost of the plant?

c) What are the annual expenses that would be recorded in surplus or deficit for 20X0 and 20X1?

Activity	Calculation	20X1 (000s CU)	20X0 (000s CU)
a) Provision			
b) Original Cost			
c) Annual Expense			
▪ **Depreciation**			
▪ **Interest 20X0**			
▪ **Interest 20X1**			
Total Expense			

Answer:

Activity	Calculation	20X1 (000s CU)	20X0 (000s CU)
a) Provision	Initial amount plus interest expense	6,249	5,895
b) Original Cost	As per requirements in IPSAS 45 – future disposal/retirement obligations CU 100,000,000 + CU 5,561,000	105,561	105,561
c) Annual Expense			
▪ **Depreciation**	CU 105,561 / 40 years	2,639	2,639
▪ **Interest 20X0**	CU 5.561 * 6%		334
▪ **Interest 20X1**	CU 5,895 * 6%	354	
Total Expense		2,993	2,973

The elements of annual expense would be depreciation expense and interest expense.

*Since discounting has been used in measuring the best estimate of the obligations to decommission the plant and ongoing management of waste material from operations, the increase in the provision that results from the passage of time is recognized as interest expense. The interest expense would be based on the discount rate used and the opening balance of the estimate before, if applicable, appropriate adjustments to the estimate in the period subsequent to initial recognition. In this case there are no adjustments.

Other Provisions

- Provisions recognized for costs of obligations under a contract expected to exceed economic benefit or service potential from it - an 'onerous contract'
- Provisions recognized for direct expenditures arising from restructuring
- If either are relevant to your situation, refer directly to IPSAS 19

An entity may have a liability for unavoidable costs of meeting obligations under a contract that exceed the economic benefit or service potential expected to be received under it (i.e., an onerous contract).

In this case the present obligation (net of recoveries) under the contract is recognized and measured as a provision.

An onerous contract is one in which the unavoidable costs of meeting the obligations under the terms of the contract exceed the economic benefits or service potential expected to be received under it, which includes amounts recoverable. Therefore, it is the present obligation net of recoveries that is recognized as a provision. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it. The costs of fulfilling a contract consist of both the incremental costs of fulfilling the contract (for example, direct materials and direct labor) and an allocation of other costs that relate directly to fulfilling contracts (for example, an allocation of the depreciation charge for an asset used in fulfilling that contract among others.

Similarly, an entity may have to recognize a provision for direct expenditures arising from the restructuring.

The following are examples of events that may fall under the definition of restructuring:

a) Termination or disposal of an activity or service;

b) The closure of a branch office or termination of activities of a government agency in a specific location or region, or the relocation of activities from one region to another;

c) Changes in management structure, for example, eliminating a layer of management or executive service; and

d) Fundamental reorganizations that have a material effect on the nature and focus of the entity's operations.

If a restructuring meets the definition of a discontinued operation, additional disclosures may be required by *IPSAS 44, Non-current Assets Held for Sale and Discontinued Operations* (see Module 8).

A restructuring provision includes only the direct expenditures arising from the restructuring, which are those that are both:

a) Necessarily entailed by the restructuring; and

b) Not associated with the ongoing activities of the entity.

Reporting requirements related to these two issues are complex and reference should be made to IPSAS 19, which covers these situations in detail

A provision for restructuring costs is recognized only when the general recognition criteria for provisions are met. IPSAS 19 provides guidance on how the general recognition criteria apply to restructurings.

Disclosures

For each class of provision

a) Opening and closing carrying amount

b) Additional provisions or increases in provisions

c) Amounts used

d) Amounts reversed

e) Increase in present value from the passage of time

f) Effect of a change in the discount rate

g) Description of nature and timing

h) Uncertainties and major assumptions

i) Expected reimbursements

Disclosures required by IPSAS 19 are intended to provide users of financial statements with information that allows them to understand the effects of accounting policies used and additional information to that presented on the face of financial statements that enables comparisons to be made for the entity over time and with other entities.

IPSAS 19 includes detailed disclosure requirements too numerous to list in the presentation material. The disclosures are based on the requirements in the standards. Once you understand the requirements, disclosure requirements are self-explanatory.

The primary disclosures for each class of provision include:

a) The carrying amount at the beginning and end of the period;

b) Additional provisions made in the period, including increases to existing provisions;

c) Amounts used (that is, incurred and charged against the provision) during the period;

d) Unused amounts reversed during the period; and

e) The increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

Comparative information is not required.

Other disclosures

An entity discloses:

a) A brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits or service potential;

b) An indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity discloses the major assumptions made concerning future events; and

c) The amount of any expected reimbursement, stating the amount of any asset that has been recognized for that expected reimbursement.

Unless the possibility of any outflow in settlement is remote, an entity discloses, for each class of contingent liability at the reporting date, a brief description of the nature of the contingent liability and, where practicable:

a) An estimate of its financial effect;

b) An indication of the uncertainties relating to the amount or timing of any outflow; and

c) The possibility of any reimbursement.

In extremely rare cases, disclosure of some or all of the information required by IPSAS 19 can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose the information, but discloses the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

The following note disclosure example has been prepared to illustrate how the main disclosure requirements in IPSAS 19 might be implemented. The example is illustrative only and matters of principle relating to particular situations should be decided in the context of the IPSAS 19. It is not intended to prescribe standardized note disclosure, as variations in format and wording will be necessary to meet the requirements of differing circumstances.

Note Disclosure Example

The Government has recognized a provision for the estimated costs related to the remediation of contaminated sites and restoration of certain assets where the it is obligated, or likely obligated to incur such costs as follows:

	20X1 000s CU	20X0 000s CU
Opening provision	2,838	2,580
Additional provisions recognized	1,733	1,872
Provision used during the period	(1,528)	(1,615)
Increase in discounted amount due to passage of time	9	1
Closing provision	3,052	2,838

Collective and Individual Services

Appendix A to IPSAS 19 provides guidance on accounting for collective and individual services. This topic is discussed in the Expenses module.

Questions and Discussion

Visit the IPSASB webpage http://www.ipsasb.org

That concludes our module on general liabilities. Participants should refer to the review questions to test themselves on their knowledge.

Review Questions

Question 1

Which of the following are not characteristics of provisions recognized as liabilities?

a) Possible obligations arising from past events;

b) Settlement will result in an outflow of resources embodying economic benefits or service potential;

c) Probable that the obligation will result in the outflow of resources.

d) A reliable estimate of the amount of the obligation can be made.

Question 2

An entity's collective agreements stipulate that vacation entitlements must be used in the fiscal period or they lapse. The entity maintains accumulated vacation banks in its payroll records and annually provides a report to employees of vacation entitlements. It has historically allowed employees to draw down banks on a FIFO basis and pays out accumulated unused days upon termination at current rates of pay.

a) Should the entity recognize a liability for unused vacation entitlements? Why?

b) If yes, is it a provision?

c) How should it be measured?

Question 3

The legislature has passed the annual budget for the government just prior to the fiscal period end. The budget provides new funding of CU 10 billion for subsidized housing for low income residents. The program will provide grants to existing non-profit agencies currently providing low rent housing units.

Should the entity recognize a liability at the reporting date for its commitment? Why?

Question 4

Before its fiscal period end 20X1, the government announced it will accept responsibility to remediate a contaminated abandoned mine site due to increasing pressure to from residents who are suffering negative health impacts from the contamination. Current legislation does not require remediation of the site. It has announced that it will construct an effluent treatment plant at the site at a cost of CU 5 million in 20X2. Ongoing operation, monitoring and testing at the site is estimated at CU 500,000 annually for 25 years commencing in 20X2.

- **a)** Does the government have a present obligation as a result of a past obligating event?
- **b)** What is the probability an outflow of resources?
- **c)** Should the government recognize a provision?
- **d)** Can a reliable estimate of the amount of the obligation be made?
- **e)** Based on the attached table what is the provision in year 1 and year 2? What is the expense?

Initial Recognition	Calculation	20X1 CU
Construction	Estimated cost	5,000,000
Estimated ongoing operating costs for 25 years	PV assuming inflation of 2% and a discounted rate of 4%	7,811,040
Liability		?????????
Expense		?????????

Change in provision	Calculation	20X2 CU
Liability, opening balance		?????????
Expenditures in period	Construction (CU 5 million) + Annual Ongoing (CU 500,000)	5,000,000
Interest expense	Increase in PV due to passage of time.	464,911
Liability, ending balance		?????????

Question 5

Is a contingent liability is disclosed when:

- **a)** A present obligation arises from a past event but there is uncertainty about both the amount and timing of the outflow of resources required to settle the obligation; or
- **b)** It is more likely that no present obligation exists at the reporting date unless the possibility of an outflow of resources is remote?

Answers to Review Questions

Question 1

The key characteristics of a liability include (b), (c) and (d). While both present obligations and possible obligations arise from past events, it is only present obligations that are recognized in the financial statements. Possible obligations are contingent liabilities. An entity does not recognize a contingent liability. A contingent liability is disclosed rather than being recognized as a provision.

Question 2

Recognition:

The entity may have a constructive obligation that it has little or no discretion to avoid. In the absence of legal enforceability, determining when an entity has little or no discretion to avoid an obligation can be a matter of professional judgment. In assessing when an entity may have a constructive obligation, one would consider evidence that an entity has created a valid expectation among others and, as a result, has no realistic alternative but to settle its obligation.

Even though the entity has clauses in collective agreements to the effect that current vacation entitlements must be used before the fiscal period end or they lapse, it has historically not enforced the policy. The entity's own actions and conduct have created a valid expectation among employees that, barring evidence to the contrary, unused vacation credits can be carried forward and used in future periods. Th s has left the entity with no realistic alternative but to settle its obligation for unused vacation entitlements.

Evidence would include the fact that the entity maintains records of accumulated unused vacation entitlements in employment records; it reports annually to employees on current vacation entitlements; it allows employees to draw down vacation banks on a FIFO basis (first in, first out) and it has paid out accumulated unused vacation credits upon terminations.

Provision:

The accumulated vacation credits are not a provision. Provisions can be distinguished from other liabilities such as payables and accruals because there is uncertainty about both the timing and amount of the future expenditure required in settlement.

The significance of the differentiation is that, in the case of provisions, the uncertainty about the amount and timing is factored into the best estimate of the expenditure required to settle the present obligation. That is, in determining the amount that the entity would rationally pay to settle the obligation at the reporting date or to transfer it to a third party at that time, the entity may use statistical estimation techniques that may consider a probability weighted range of possible outcomes.

It may use a present value approach where the effect of the time value of money is material. In such cases, discount rates reflect current market assessments of the time value of money and the risks specific to the liability.

Payables are liabilities to pay for goods or services that have been received or supplied, and have been invoiced or formally agreed with the supplier Accruals are liabilities to pay for goods or services that have been received or supplied, but that have not been paid, invoiced, or formally agreed with the supplier, including amounts due to employees (for example, amounts relating to accrued vacation pay). Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions. Accruals are often reported as part of accounts payable, whereas provisions are reported separately.

Measurement:

The liability for unused vacation credits would meet the general recognition criteria. There is an appropriate basis of measurement, and a reasonable estimate can be made of the amount involved. For liabilities incurred, the transactions are generally initially recognized in financial statements at the amount of cash or cash equivalents to be paid. However, in the case of accruals, it is sometimes necessary to estimate the amount or timing of settlement. The preparation of financial statements requires the use of reasonable estimates and does not undermine their reliability. Future events may affect the amount required to settle an obligation and should be reflected in the estimate where there is sufficient objective evidence that they will occur.

In this case, because the entity has a past practice of allowing draw down or paying out unused vacation credits at current rates of pay, the estimate of the accrual should take into account the expected future salary adjustments.

Because of the time value of money, provisions relating to cash outflows that arise soon after the reporting date are more onerous than those where cash outflows of the same amount arise later. Where the effect of the time value of money is material, the estimate is based on the present value of the expenditures expected to be required to settle the obligation. For example, if experience shows that employees bank unused vacation credits for draw down or payout at retirement, the estimate could be based on the present value of the forecast amount and timing of expenditures to settle the obligation.

The discount rate used reflects current market assessments of the time value of money and the risks specific to the liability. Where discounting is used, the increase in the carrying amount of a liability attributable to the passage of time is recognized as an interest expense.

Question 3

The government does not have a constructive obligation. Determining when an entity has little or no discretion to avoid the obligation can be a matter of professional judgment. In assessing when an entity may have lost its discretion to make decisions and judgments, one would consider whether an entity has created a valid expectation among others and, as a result, has no realistic alternative but to settle its obligation. It is the preponderance of evidence that determines whether a government has little or no discretion.

For these types of obligations, a government has little or no discretion when there is a sufficient evidence that:

a) the government acknowledges and indicates it will act upon its decision to accept responsibility for the obligation; and

b) the government has sufficiently communicated its decision to the affected parties.

Evidence that a government has sufficiently communicated its decision to affected parties could include, but is not limited to, the following:

a) an announcement of the amount the government is providing;

b) identification of the individuals, organizations or groups affected by the decision; and

c) an announcement of the time frame for implementing the decision.

In this case, the government may have communicated its intention to implement a new program, but it has not announced the specific terms of the new program and the eligibility criteria for recipients. The government has announced the total amount of the program, but has not identified specific agencies that will receive funding, the amount of the grants nor the time frame for implementation of the program. In this case, the government has not created a valid expectation among the potential recipients sufficient for them to have placed reliance on the government meeting its commitment and, as a result, the government can realistically withdraw from that commitment.

Question 4

a) Does the government have a present obligation as a result of a past obligating event?

The government has a constructive obligation as a result of its announcement that has created a valid expectation on the part of other parties that leaves it with little or no discretion. The government acknowledges and indicates it will act upon its decision to accept responsibility for the obligation; and the government has sufficiently communicated its decision to the affected parties. The announcement of the included the amount the government is providing and the time frame for implementing the decision.

b) What is the probability an outflow of resources?

It is probable that an outflow of economic resources will be required to settle the obligation.

c) Should the government recognize a provision?

The government has a present obligation as a result of a past event. It is probable that an outflow of resource embodying economic benefits or service potential will be required to settle the obligation. A provision should be recognized if a reliable estimate can be made of the amount of the obligation.

d) Can a reliable estimate of the amount of the obligation be made?

From the information available from site assessments a reliable estimate can be made of the amount of the obligation. The government can arrive at the best estimate of the expenditure required to settle the present obligation at the reporting date.

e) Based on the attached table what is the provision in year 1 and year 2? What is the expense?

Initial Recognition	Calculation	20X1 CU
Construction	Estimated cost	5,000,000
Estimated ongoing operating costs for 25 years	PV assuming inflation of 2% and a discounted rate of 4%	7,811,040
Liability		12,811,040
Expense		12,811,040

Change in provision	Calculation	20X2 CU
Liability, opening balance		12,811,040
Expenditures in period	Construction (CU 5 million) + Annual Ongoing (CU 500,000)	5,500,000
Interest expense	Increase in PV due to passage of time.	464,911
Liability, ending balance		7,775,951

Expenditures that relate to the original provision are set against it. Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognized as an interest expense.

Question 5

The answer is (b).

In a general sense, all provisions are contingent because they are uncertain in timing or amount. The preparation of financial statements requires the use of reasonable estimates and does not undermine their reliability. There is a degree of uncertainty associated with the measurement of many amounts recognized or disclosed in the financial statements. Just because an estimate is involved does not mean that an item does not meet the criteria for recognition. Except in extremely rare cases, an entity will be able to determine a range of possible outcomes, and can therefore make an estimate of the obligation that is sufficiently reliable to use in the preparation of financial statements.

The term contingent is used for liabilities that are not recognized because;

- **a)** Their existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity;
- **b)** They do not meet the recognition criteria because either it is not probable that an outflow of resources will be required or a sufficiently reliable estimate of the amount of the obligation cannot be made.

Employee Benefits: Short-Term, Long-Term & Termination Benefits

Employee Benefits: Short-Term, Long-Term & Termination Benefits

The Handbook of International Public Sector Accounting Pronouncements is the primary authoritative source of international generally accepted accounting standards for public sector entities.

Specific topics include:

- Scope of the IPSAS 39 on accounting and reporting employee benefits;
- Definitions of the four major commonplace public sector categories of employee benefits (short-term employee benefits, post-employment benefits, other long-term employee benefits and termination benefits); and
- Recognition, measurement and disclosure requirements for each major category (except post-employment benefits which is covered in a separate module).

The labor-intensive character of the operations of many public sector entities means that liabilities and expenses related to employee benefits are likely to be particularly significant in evaluating the financial performance and financial position of those entities.

This module focuses on requirements of IPSAS 39, *Employee Benefits*. IPSAS 39 prescribes the recognition, measurement, presentation and disclosure requirements for employee benefits in the financial statements of public sector entities.

Applying the requirements of IPSAS 39 may prove challenging for many public sector entities. Currently,many public sector entities may not be recognizing liabilities related to employee benefits, and may therefore not have the systems in place to provide the information required for reporting under this Standard. Where entities are recognizing liabilities relating to employee benefits, this may be on a different basis to that required by IPSAS 39. In some cases, adoption of IPSAS 39 might give rise to tensions with budgetary projections and other prospective information. Accounting for employee benefits requires management to make judgments, apart from those involving estimations, in the process of applying the standards in IPSAS 39.

Scope of IPSAS 39

- Deals with accounting by public sector entities for all employee benefits
- Provided:
  - Under formal plans
  - Legislative requirements
  - Informal practices

Note - Funding not required.

The employee benefits to which IPSAS 39 applies include those provided:

a) Under formal plans or other formal agreements between an entity and individual employees, groups of employees, or their representatives;

b) Under legislative requirements, or through industry arrangements, whereby entities are required to contribute to national, state, industry, or other multi-employer plans, or

c) By those informal practices that give rise to a constructive obligation. Informal practices give rise to a constructive obligation where the entity has no realistic alternative but to pay employee benefits. An example of a constructive obligation is where a change in the entity's informal practices would cause unacceptable damage to its relationship with employees.

IPSAS 39 requires recognition of the liabilities for employee benefits and allocating the expense to the appropriate reporting period, but does not require funding of the liabilities.

The accounting objective is to measure and report the obligation for employee retirement benefits and to attribute the expense to the periods in which the entity consumes the economic benefits or service potential arising from service provided by an employee in exchange for employee benefits.

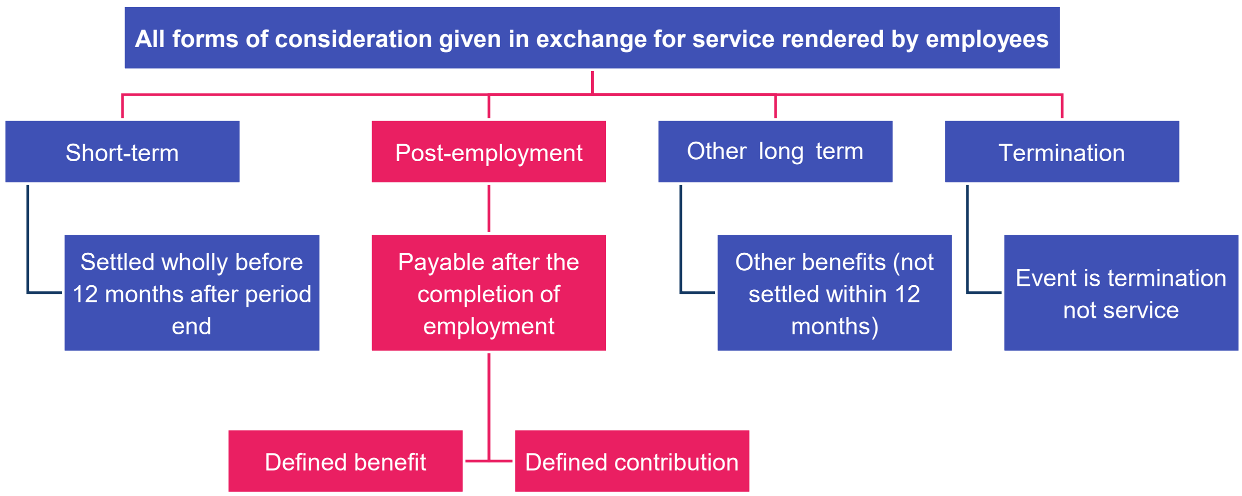
Determining whether an employee benefit plan should be funded and the amount to be funded each period is a financial management matter. The funding objective is to determine an acceptable policy for financing the estimated ultimate cost of an employee benefit plan.

Because the objectives of a funding policy are not necessarily the same as the accounting objective, the liability for accounting purposes may not be the same as the amount not yet funded at the financial statement date. In addition, the expense of the period for accounting purposes may not be the same as the contribution to the employee benefit plan in the period for funding purposes.

However, the recognition of the liability and the detailed measurement and disclosure requirements for plan assets, if any, brings awareness of the implications of the growing obligation. Recognition highlights the need to develop funding strategies that spreads the cash flow burden over extended future fiscal periods and opportunities to tighten eligibility requirements to manage future growth of obligations.

While these requirements apply to all employee benefits, they are often less significant for short term employment benefits and termination benefits.

Employee benefits are all forms of consideration given by an entity in exchange for service rendered by employees.



Definitions

Employee benefits covered by IPSAS 39 are one of four common types:

Short-term employee benefits are employee benefits (other than termination benefits) that are due to be settled wholly before twelve months after the end of the reporting period in which the employees render the related service.

Short-term employee benefits include items such as:

- **a)** Wages, salaries, and social security contributions;
- **b)** Paid annual leave and paid sick leave;
- **c)** Profit-sharing and bonuses; and
- **d)** Non-monetary benefits (such as medical care, housing, cars, and free or subsidized goods or services) for current employees.

IPSAS 39 includes employee benefits resulting from profit-sharing, bonuses, and deferred compensation. These types of short-term employee benefits are not covered in-depth because of the objectives of public sector entities, these types of employee benefits are far less common in the public sector than for profit-oriented entities. They may be an issue for public sector entities that operate on a commercial basis. Also, some public sector entities may have bonus plans that are related to service delivery objectives or aspects of financial performance such as achievement of budget targets.

The major issue with their recognition is the determination of when the entity has no realistic alternative but to make the payments. For example, an entity may have no legal obligation to pay; however, because it may have a past practice of paying bonuses, it is left with no realistic alternative but to make payment.

As well, the requirements for measurement are complex and beyond the scope of this material. If an entity has these types of benefits, it should refer directly to IPSAS 39 for guidance.

Briefly, IPSAS 39 provides that an obligation under a bonus plan results from employee service and is recognized as an expense in surplus or deficit if it can be reliably measured. A reliable estimate is possible when:

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

Post-employment benefits are employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment.

Post-employment benefits include, for example:

- **a)** Retirement benefits, such as pensions; and
- **b)** Other post-employment benefits, such as post-employment life insurance, and post-employment medical care.

Post-employment benefit plans are formal or informal arrangements under which an entity provides post-employment benefits for one or more employees. An entity applies IPSAS 39 to all such arrangements, whether or not they involve the establishment of a separate entity (such as a superannuation scheme, pension scheme, or retirement benefit scheme) to receive contributions and to pay benefits.

Post-employment benefits are covered in more detail in a separate module.

Other long-term employee benefits are all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits.

Other long-term employee benefits may include the following where they are not expected to be settled wholly before twelve months after the end of the reporting period in which the employees render the related service:

- **a)** Long-term compensated absences such as long service or sabbatical leave;
- **b)** Jubilee or other long service benefits;
- **c)** Long-term disability benefits;
- **d)** Profit sharing and bonuses
- **e)** Deferred remuneration; and
- **f)** Compensation payable by the entity until an individual enters new employment.

Termination benefits are employee benefits provided in exchange for the termination of an employee's employment as a result of either:

- **a)** An entity's decision to terminate an employee's employment before the normal retirement date; or
- **b)** An employee's decision to accept an offer of benefits in exchange for the termination of employment.

IPSAS 39 deals with termination benefits separately from other employee benefits, because the event which gives rise to an obligation is the termination rather than employee service.

Termination benefits are typically lump-sum payments, but sometimes also include:

- **a)** Enhancement of post-employment benefits, either indirectly through an employee benefit plan or directly; and
- **b)** Salary until the end of a specified notice period if the employee renders no further service that provides economic benefits to the entity.

Some employee benefits are payable regardless of the reason for the employee's departure. The payment of such benefits is certain (subject to any vesting or minimum service requirements) but the timing of their payment is uncertain. Although such benefits are described in some countries as termination indemnities, or termination gratuities, they are post-employment benefits rather than termination benefits, and an entity accounts for them as post-employment benefits.

Some termination benefits are provided in accordance with the terms of an existing employee benefit plan. Employee benefits provided in accordance with the terms of an employee benefit plan are termination benefits if they both result from an entity's decision to terminate an employee's employment and are not conditional on future service being provided.

Type of Benefit

Scenario

An entity provides 20 days of paid vacation leave for senior administrative staff. Employees are allowed to bank unused annual vacation entitlement.

Banked days can be taken or paid out on termination or retirement at the rate of pay at that time.

- What type of employee benefit is the unused vacation leave? Explain.

Answer:

The unused vacation leave is not:

a) A short-term employee benefit since it is not due to be settled within 12 months of the fiscal period end;

b) A post- employment benefit as it is not payable after the completion of employment;

c) A termination benefit since it is not payable as a result of a decision to terminate employment or an employee's decision to accept an offer of benefits in exchange for the termination of employment.

The unused vacation leave is not a termination benefit on two accounts. First it results from service rendered by employees. Secondly, it is not payable as a result of termination.

The unused vacation leave classified is "other long-term employee benefits." That is, employee benefits other than short-term employee benefits, post-employment benefits and termination benefits.

Short-Term Benefits

- Recognize the undiscounted amount of short-term employee benefits expected to be paid as a liability
- Compensation for absences
    - Accumulating compensation increases with employee service – recognize liability for vesting; partial liability for non-vesting
    - Non-accumulating benefits recognized when absence occurs
- Bonuses – recognize when obligation to pay

Consider materiality when estimating liability for short-term benefits.

Accounting for short-term employee benefits is generally straightforward, because no actuarial assumptions are required to measure the obligation or the cost, and there is no possibility of any actuarial gain or loss. Short-term employee benefit obligations are measured on an undiscounted basis.

When an employee has rendered service to an entity during an accounting period, the entity recognizes the undiscounted amount of short-term employee benefits expected to be paid in exchange for that service as a liability (accrued expense), and an expense.

When dealing with compensated absences, you must determine whether they are accumulating or non-accumulating.

Accumulating compensated absences are carried forward and can be used in future periods. They can be **vesting**, meaning the employee can receive cash for unused amounts on leaving or **non-vesting**, meaning there is no entitlement to cash for unused amounts on leaving.

Accumulating compensation increases with employee service — if vesting then a liability is recognized; if non-vesting then a partial liability (which takes into account the possibility of the employee leaving) is recognized.

Non-accumulating benefits lapse if they are not used and so no liability or expense is recognized until the absence occurs because employee service does not affect the amount of the benefit.

Illustrative Example

Scenario

An entity has 100 employees each entitled to five days paid sick leave per year. Unused days are carried forward for one calendar year. Sick leave is used on a last in, first out (LIFO) basis (i.e., the current year's entitlement is used first; and then the balance brought forward). At December 31, 20X1, the average unused entitlement is two days per employee. In 20X2 based on experience only eight employees will exceed current entitlement taking an average of six and a half days.

Is the liability for unused sick days at December 20X1 (a) 200 days (b) 16 days (c) 12 days? Explain.

Answer

The answer is (c). The entity expects that it will pay an additional 12 days of sick pay as a result of the unused entitlement that has accumulated at 31 December 20X1 (one and a half days each, for eight employees). Therefore, the entity recognizes a liability equal to 12 days of sick pay.

Other Long-Term Benefits

- Recognition and measurement similar to post-employment benefits
- Measurement not usually subject to same degree of uncertainty
- Simplified method of accounting
  - Remeasurements are recognized in Surplus or Deficit, not Net Assets/Equity

The accounting for other long-term benefit plans is similar to that for post-employment benefits

The amount recognized as a liability for other long-term employee benefits is the net total of the following amounts:

a) The present value of the defined benefit obligation at the reporting date using the Projected Unit Credit Method;

b) Minus the fair value (as defined in IPSAS 46, *Measurement*, at the reporting date of plan assets (if any) out of which the obligations are to be settled directly.

The measurement of other long-term employee benefits is not usually subject to the same degree of uncertainty as the measurement of post-employment benefits. For this reason, IPSAS 39 requires a simplified method of accounting for other long-term employee benefits. Unlike the accounting required for post-employment benefits, this method does not recognize remeasurements in net assets/equity but in Surplus or Deficit.

In measuring the liability, an entity applies the same requirements as for post-employment benefits when recognizing and measuring the defined benefit obligation and the plan assets.

For other long-term employee benefits, an entity recognizes the net total of the following amounts in Surplus or Deficit, except to the extent that another Standard requires or permits their inclusion in the cost of an asset:

a) Service cost;

b) Net interest on the net defined benefit liability (asset); and

c) Remeasurements of the net defined benefit liability (asset).

For further details, see the description of the requirements for post-employments benefits later in this Module.

Termination Benefits

- Entity's decision to terminate employment or employee's decision to accept termination of employment
- Recognize termination benefits at the earlier of the following dates:
    - When the entity can no longer withdraw the offer of those benefits; and
    - When the entity recognizes costs for a restructuring that involves the payment of termination benefits.

Termination benefits are dealt with separately from other employee benefits because the event which gives rise to an obligation is the termination of employment rather than employee service. Termination benefits do not provide an entity with future economic benefits, and are recognized as an expense immediately.

An entity recognizes a liability and an expense for termination benefits at the earlier of the following dates

a) When the entity can no longer withdraw the offer of those benefits; and

b) When the entity recognizes costs for a restructuring that is within the scope of IPSAS 19 and involves the payment of termination benefits.

The time when an entity can no longer withdraw the offer of termination benefits is as follows:

When payable as a result of an employee's decision to accept an offer, is the earlier of:

a) When the employee accepts the offer; and

b) When a restriction on the entity's ability to withdraw the offer takes effect. This would be when the offer is made, if the restriction existed at the time of the offer.

When payable as a result of an entity's decision to terminate an employee's employment, when the entity has communicated to the affected employees a plan of termination meeting all of the following criteria:

a) Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made.

b) The plan identifies the number of employees whose employment is to be terminated, their job classifications or functions and their locations (but the plan need not identify each individual employee) and the expected completion date.

c) The plan establishes the termination benefits that employees will receive in sufficient detail that employees can determine the type and amount of benefits they will receive when their employment is terminated.

Questions and Discussion

Visit the IPSASB webpage http://www.ipsasb.org

That concludes our module on general liabilities. Participants should refer to the review questions to test themselves on their knowledge.

Review Questions

Question 1

Short-term employee benefits are employee benefits that are due to be settled within twelve months after the end of the period in which the employees render the related service. Which of the following is not a short-term employee benefit? Why?

- a) Wages, salaries, bonuses and social security contributions
- b) Performance bonuses payable 15 months after the end of the reporting period;
- c) Annual vacation leave that is allowed to be carried over for one period.

Question 2

An entity's employees are entitled to 20 days of paid holiday leave per calendar year. Unused holiday leave can be carried forward until the employee terminates employment with the entity at which time the entity will pay the employee for all unused holiday leave (it accumulates and vests). Is the holiday leave:

- a) Short-term employee benefits
- b) Post-employment benefits
- c) Other long-term employee benefits
- d) Termination benefits

Question 3

An entity reimburses 50% of past employees' medical expense between the date of retirement and attainment of age 65 if the employee has 25 years or more of service to the entity. The obligation to pay 50% of qualifying past employees' post-employment medical expenses is:

- a) Short-term employee benefits
- b) Post-employment benefit - defined contribution plan
- c) Post-employment benefit - defined benefit plan
- d) Other long-term employee benefits
- e) Termination benefits

Question 4

A government has decided to restructure its operations, resulting in a need for fewer employees. The government offers a cash settlement to any employees who are willing to accept redundancy.

Which of the following describes the cash settlement?

a) Short-term employee benefits

b) Post-employment benefits

c) Other long-term employee benefits

d) Termination benefits

Question 5

A short-term employee benefit is recognized as which of the following:

a) As a liability and an expense at the undiscounted amount expected to be paid after deducting amounts already paid

b) As a liability and expense at the present value of the amount expected to be paid

c) As a liability and an expense, unless another standard requires or permits the inclusion of the benefits in the cost of an asset, at the undiscounted amount expected to be paid, after deducting amounts already paid

Question 6

An entity's employees are each entitled to 10 days of sick leave per year. Unused sick days are carried forward for one year. Carried forward days are used first. Unused sick leave does not vest.

Is the unused sick leave:

a) a short-term employee benefit

b) a post-employment benefit

c) an other long-term employee benefit

d) a termination benefit?

How does the fact that unused sick days do not vest affect the recognition and measurement of the obligation?

Question 7

The facts are the same as in Question 6, except that unused sick leave can be carried forward until an employee has accumulated 220 days in his or her sick leave bank. Experience shows that as employees approach retirement, sick leave usage rises such that when most employees retire, their accumulated sick leave banks are depleted.

- Does this affect the answer to Question 6? Why?

- How does this affect the recognition and measurement of the obligation?

Answers to Review Questions

Question 1

The correct answer is (b).

The performance bonus will be paid in a fiscal period beyond the current period plus 12 months.

Question 2

The answer is (c).

The answer is based on the definitions contained in IPSAS 39.

The benefit is not a short-term employee benefit since the benefit is not due to be settled wholly before 12 months after the end of the period in which the employees render related service. Short-term-employee benefits are employee benefits (other than termination benefits) that are due to be settled wholly before twelve months after the end of the reporting period in which the employees render the related service.

Although the benefit may be paid upon terminations, it is not a post-employment benefit or a termination benefit. Post-employment benefits are employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment. Termination benefits are employee benefits payable as a result of either an entity's decision to terminate an employee's employment before the normal retirement date; or an employee's decision to employee's decision to accept an offer of benefits in exchange for the termination of employment.

By elimination, the unused vacation benefits would be "other long-term benefits. Other long-term employee benefits are all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits.

Question 3

The answer is (c).

Under the plan, the entity has an obligation to provide reimbursement of 50% of medical expenses incurred to former employees after the completion of their employment. Therefore it meets the definition of a post-employment benefit plan.

It is not a defined contribution plan since the obligation is not limited to the payment of fixed contributions into a separate entity. Therefore, it is a defined benefit plan.

Although the post-employment benefits only become payable if the retired employee incurs an eligible medical expense, the entity still incurs an obligation as the employee renders service. Under IPSAS 39, an obligation is created when the employee renders service that will provide entitlement to the benefit if the specified event occurs. The probability that the specified event will occur affects the measurement of the obligation, but does not determine whether the obligation exists.

Question 4

The correct answer is (d).

The definitions of short-term, post-employment and other long-term employee benefits specifically exclude termination benefits. That is because the former types of benefits are given by an entity in exchange for service rendered by employees. IPSAS 39 deals with termination benefits separately because the event that gives rise to an obligation is the termination rather than employee service. That is, termination benefits are not employee benefits given by an employer in exchange for service rendered by employees.

The distinction is important because it has an impact on the recognition criteria for termination benefits.

Question 5

The answer is (c).

When an employee has rendered service to an entity during an accounting period, the entity shall recognize the undiscounted amount of short-term employee benefits expected to be paid in exchange for that service:

- **a)** As a liability (accrued expense), after deducting any amount already paid. If the amount already paid exceeds the undiscounted amount of the benefits, an entity shall recognize that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund; and
- **b)** As an expense, unless another Standard requires or permits the inclusion of the benefits in the cost of an asset (see, for example, IPSAS 12, *Inventories*, and IPSAS 45, *Property, Plant, and Equipment*).

Question 6

The sick leave benefit is (a), a short-term employee benefits.

This is an accumulating compensated absence employee benefit. However, since the employee benefit is due to be settled within twelve months after the end of the period in which the employees render the related service, the short-term employee benefit obligation is measured on an undiscounted basis.

In this case, since the unused sick days do not vest, the entity would estimate the liability based on its expectations about the number of carried forward sick days that will be used in the subsequent year. For example, if is expected that 25% of the unused days would be used in the subsequent period, it would estimate the liability based on estimated average earnings per day times 25% of total unused sick days carried forward.

If the unused sick leave vested, the benefit would be measured at the amount that would be paid out..

Question 7

The sick leave benefit is classified as Other Long-Term Employee Benefits. The significance is that short-term employee benefits are recognized and measured as the undiscounted amounts expected to be paid.

The amount recognized as a liability for other long-term employee benefits is the net total of the following amounts:

- **a)** The present value of the defined benefit obligation at the reporting date;
- **b)** Minus the fair value (as defined in IPSAS 46, *Measurement*) at the reporting date of plan assets (if any) out of which the obligations are to be settled directly.

The benefit is an accumulating compensated absence. Sick days can be carried forward and can be used in future periods if the current period's entitlement is not used in full. The obligation arises as employees render service that increases their entitlement to future compensated absences.

The entity uses the Projected Unit Credit Method to determine the present value of its defined benefit obligation and the related current service cost.

Employee Benefits: Post-Employment Benefits

Employee Benefits: Post-Employment Benefits

The Handbook of International Public Sector Accounting Pronouncements is the primary authoritative source of international generally accepted accounting standards for public sector entities.

The accounting for employee benefit plans is complex requiring actuarial assumptions to measure the obligation and the expense, the treatment of actuarial gains and losses and the use of estimation techniques that account for the fact that the obligations may be settled many years after the employees render the related service. The liability may involve not only a legal obligation under the formal terms of benefit plans, but also constructive obligations that arise from an entity's informal practices. This is one area that is likely to cause a significant change when entities are transitioning to a full accrual basis of accounting.

The labor-intensive character of the operations of many public sector entities means that liabilities and expenses related to employee benefits are likely to be particularly significant in evaluating the financial performance and financial position of those entities.

This module focuses on requirements of IPSAS 39, Employee Benefits. IPSAS 39 prescribes the recognition, measurement, presentation and disclosure requirements for employee benefits in the financial statements of public sector entities.

Applying the requirements of IPSAS 39 may prove challenging for many public sector entities. Currently, many public sector entities may not be recognizing liabilities related to employee benefits, and may therefore not have the systems in place to provide the information required for reporting under IPSAS 39. Where entities are recognizing liabilities relating to employee benefits, this may be on a different basis to that required by IPSAS 39. In some cases, adoption of IPSAS 39 might give rise to tensions with budgetary projections and other prospective information. Accounting for employee benefits requires management to make judgments, apart from those involving estimations, in the process of applying the standards in IPSAS 39.

Post-Employment Benefits

- Can be significant for public sector entities
- Payable after completion of employment
  - Defined contribution plans
    - Liability limited to annual fixed contributions
    - Actuarial and investment risk borne by employee
  - Defined benefit plans
    - Entity's obligation is to provide agreed benefits
    - Actuarial and investment risk borne by employer
  - Multi-Employer Plans

This module deals with recognition, measurement and disclosures related to post-employment benefits.

These include retirement benefits like pensions and other post-employment benefits like life insurance and medical care. Both defined contribution and defined benefit plans will be addressed. This classification is based on the economic substance of the plan.

IPSAS 39 does not deal with the accounting by a retirement benefit plan. Retirement benefit plans should refer to *IPSAS 49, Retirement Benefit Plans* (see Module 8).

For defined contribution plans, an entity's obligation is limited to the amount the entity contributes to the fund. The employee receives post-employment benefits based on the contributions made to the plan plus investment returns. The employee bears the actuarial and investment risk, i.e., the risks that benefits will be less than expected and that the assets invested will be insufficient to meet expected benefits.

For defined benefit plans the entity agrees to provide agreed benefits, which means the actuarial and investment risk lies with the employer.

Multi-employer plans are not addressed in this module; IPSAS 39 includes guidance should participants require more details.

Defined Contribution Plans

- Paid in exchange for service rendered by employees
- Contributions payable recognized as a liability and an expense
- Contributions not due within twelve months of period end are discounted
- The amount recognized as an expense for the period must be disclosed

Accounting for defined contribution plans is relatively straight forward because the entity's obligation for each period is determined by the amounts to be contributed for that period. Consequently, no actuarial assumptions are required to measure the obligation or the expense, and there are no actuarial gains or losses. Obligations are measured on an undiscounted basis, unless they are not expected to be settled wholly before twelve months after the end of the period in which the employees render the related service – in this case they are discounted.

When an employee has rendered service to an entity during a period, the entity recognizes the contribution payable to a defined contribution plan in exchange for that service as a liability, after deducting any contribution already paid, and as an expense, unless another Standard requires or permits the inclusion of the contribution in the cost of an asset (see, for example, IPSAS 12 and IPSAS 45).

An entity must disclose the amount recognized as an expense for defined contribution plans.

Illustrative Example

Scenario

Annual contributions of 2% of annual gross earnings are due to a defined contribution plan. For the year ended December 31, 20X1 gross earnings totaled CU 15 million and payments were made of CU 350,000 (of which CU 150,000 was for 20X0).

- Is the expense for period (a) CU 350,000 (b) CU 300,000 (c) CU 200,000? Explain.
- Is the liability at Dec 31, 20X1(a) CU 300,000 (b) CU 100,000 (c) Nil? Explain.
- Is the expense (a) CU 500,000 (b) CU 300,000 if the entity paid CU 500,000? Explain.

Answer

a) The expense for the fiscal period is (b) CU 300,000. The contribution payable to a defined contribution plan is recognized as an expense in the period when an employee has rendered service on the same basis as for short-term employee benefits. The calculation is:

*Gross earnings CU 15 million * 2% = CU 300,000*

b) The liability at December 31, 20X1 is (b) CU 100,000 calculated as follows:

CU 300,000 – paid in period for current service CU 200,000 = CU 100,000

c) If the entity made payments totaling CU 500,000, the expense would be (b) CU 300,000. It would record an asset (prepaid expense) of CU 50,000. The amount paid exceeds the contributions expected to be paid to the extent that the prepayment will lead to a reduction in future payments. The calculations are as follows:

(CU 500,000 – CU 150,000) less expense CU 300,000 = CU 50,000 (prepaid)

Defined Benefit Plans

- Complex
- Require actuarial assumptions- usually qualified actuary involved
- Maybe unfunded, partially funded or wholly funded
- Include some pension plans, post-employment life insurance and medical plans

Accounting for defined benefit plans is complex because actuarial assumptions are needed to measure the obligation and expense. There is also the possibility of actuarial gains and losses and the obligations are discounted because they may be settled many years after the employees provide the services.

Defined benefit plans may be funded, partially funded or unfunded – pensions may be funded or partially funded due to legislative requirements; other post-employment benefits are less likely to be funded.

The fundamental accounting task is to determine the amount of the obligation for retirement benefits to attribute to each period of employee service. This means determining the amount of the liability at the financial statement date and the value of the benefits employees earned during the period, which represents the expense of that period.

This section is focused on those two calculations – the net defined benefit liability (asset) and the cost of benefits earned – and goes through the elements of each of these amounts.

The ultimate cost of a defined benefit plan may be influenced by many variables, such as final salaries, employee turnover and mortality, medical cost trends and, for a funded plan, the investment earnings on the plan assets. The ultimate cost of the plan is uncertain and this uncertainty is likely to persist over a long period of time.

Employee service gives rise to an obligation under a defined benefit plan even if the benefits are conditional on future employment (in other words, they are not vested). Employee service before the vesting date gives rise to a constructive obligation because, at each successive reporting date, the amount of future service that an employee will have to render before becoming entitled to the benefit is reduced. In measuring its defined benefit obligation, an entity considers the probability that some employees may not satisfy any vesting requirements.

Accounting for defined benefit plans is complex, because actuarial assumptions are required to measure the obligation and the expense. Determining such amounts involves not only accounting for past transactions and events; it also requires assumptions about future events, such as inflation, investment returns, medical costs and employee turnover and mortality. It is probable that actual experience differs from the actuarial assumptions made about future economic events resulting in actuarial gains and losses. Moreover, the obligations are measured on a discounted basis, because they may be settled many years after the employees render the related service.

Most organizations involve a qualified actuary in the measurement of all material post-employment benefit obligations. Most organizations do not have the internal capacity to complete an actuarial valuation of post-employment benefits.

Determining the Net Defined Benefit Liability (Asset)

- Determine deficit or surplus
  - Estimate of the ultimate cost to the entity using an actuarial technique (the projected unit credit method)
  - Discount that cost to determine the present value of the defined benefit obligation
  - Deduct the fair value (as defined in IPSAS 46) of any plan assets from the present value of the defined benefit obligation
- Determine net defined benefit liability (asset)
  - Deficit or surplus determined as above, adjusted for any effect of limiting a net defined benefit asset to the asset ceiling

Accounting by an entity for defined benefit plans involves the following steps:

a) Determining the deficit or surplus. This involves:

(i) Using an actuarial technique, the projected unit credit method, to make a reliable estimate of the ultimate cost to the entity of the benefit that employees have earned in return for their service in the current and prior periods. This requires an entity to determine how much benefit is attributable to the current and prior periods and to make estimates (actuarial assumptions) about demographic variables (such as employee turnover and mortality) and financial variables (such as future increases in salaries and medical costs) that will affect the cost of the benefit;

(ii) Discounting that benefit in order to determine the present value of the defined benefit obligation and the current service cost;

(iii) Deducting the fair value (as defined in IPSAS 46) of any plan assets from the present value of the defined benefit obligation.

b) Determining the amount of the net defined benefit liability (asset) as the amount of the deficit or surplus determined in (a), adjusted for any effect of limiting a net defined benefit asset to the asset ceiling.

c) Determining amounts to be recognized in surplus or deficit.

d) Determining the remeasurements of the net defined benefit liability (asset), to be recognized in net assets/equity.

An entity determines the net defined benefit liability (asset) with sufficient regularity that the amounts recognized in the financial statements do not differ materially from the amounts that would be determined at the end of the reporting period.

An entity accounts not only for its legal obligation under the formal terms of a defined benefit plan, but also for any constructive obligation that arises from the entity's informal practices.

Amounts to be Recognized in Surplus or Deficit

- Current Service Cost
  - Current service cost is the increase in the present value of the defined benefit obligation resulting from employee service in the current period.
- Any past service cost and gain or loss on settlement
  - Past service cost is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment or a curtailment
- Net interest on the net defined benefit liability (asset)

Current Service Cost

An entity uses the projected unit credit method to determine the present value of its defined benefit obligations and the related current service cost and, where applicable, past service cost.

The projected unit credit method (sometimes known as the accrued benefit method prorated on service or as the benefit/years of service method) sees each period of service as giving rise to an additional unit of benefit entitlement, and measures each unit separately to build up the final obligation.

In determining the present value of its defined benefit obligations and the related current service cost and, where applicable, past service cost, an entity attributes benefit to periods of service under the plan's benefit formula. However, if an employee's service in later years will lead to a materially higher level of benefit than in earlier years, an entity should attribute benefit on a straight-line basis from:

a) The date when service by the employee first leads to benefits under the plan (whether or not the benefits are conditional on further service) until

b) The date when further service by the employee will lead to no material amount of further benefits under the plan, other than from further salary increases.

The projected unit credit method requires an entity to attribute benefit to the current period (in order to determine current service cost) and the current and prior periods (in order to determine the present value of defined benefit obligations). An entity attributes benefit to periods in which the obligation to provide post-employment benefits arises. That obligation arises as employees render services in return for post-employment benefits that an entity expects to pay in future reporting periods. Actuarial techniques allow an entity to measure that obligation with sufficient reliability to justify recognition of a liability.

Employee service gives rise to an obligation under a defined benefit plan even if the benefits are conditional on future employment (in other words they are not vested). Employee service before the vesting date gives rise to a constructive obligation because, at the end of each successive reporting period, the amount of future service that an employee will have to render before becoming entitled to the benefit is reduced.

In measuring its defined benefit obligation, an entity considers the probability that some employees may not satisfy any vesting requirements.

The obligation increases until the date when further service by the employee will lead to no material amount of further benefits. Therefore, all benefit is attributed to periods ending on or before that date.

Benefit is attributed to individual accounting periods under the plan's benefit formula. However, if an employee's service in later years will lead to a materially higher level of benefit than in earlier years, an entity attributes benefit on a straight-line basis until the date when further service by the employee will lead to no material amount of further benefits. That is because the employee's service throughout the entire period will ultimately lead to benefit at that higher level.

Past Service Cost

Past service cost is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or a curtailment (a significant reduction by the entity in the number of employees covered by a plan).

When determining past service cost, or a gain or loss on settlement, an entity shall remeasure the net defined benefit liability (asset) using the current fair value of plan assets and current actuarial assumptions (including current market interest rates and other current market prices), reflecting:

- **a)** The benefits offered under the plan and the plan assets before the plan amendment, curtailment or settlement; and
- **b)** The benefits offered under the plan and the plan assets after the plan amendment, curtailment or settlement.

An entity need not distinguish between past service cost resulting from a plan amendment, past service cost resulting from a curtailment and a gain or loss on settlement if these transactions occur together. In some cases, a plan amendment occurs before a settlement, such as when an entity changes the benefits under the plan and settles the amended benefits later. In those cases, an entity recognizes past service cost before any gain or loss on settlement.

Net Interest on the Net Defined Benefit Liability (Asset)

An entity determines net interest on the net defined benefit liability (asset) by multiplying the net defined benefit liability (asset) by the discount rate.

To determine net interest, an entity uses the net defined benefit liability (asset) and the discount rate determined at the start of the annual reporting period.

Net interest on the net defined benefit liability (asset) can be viewed as comprising interest revenue on plan assets, interest cost on the defined benefit obligation and interest on the effect of the asset ceiling (if any).

The rate used to discount post-employment benefit obligations (both funded and unfunded) should reflect the time value of money. The currency and term of the financial instrument selected to reflect the time value of money should be consistent with the currency and estimated term of the post-employment benefit obligations.

Remeasurements of net defined benefit liability (asset) recognized in net assets/equity

- Actuarial gains and losses
- Return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset)
- Any change in the effect of the asset ceiling

Actuarial Gains and Losses

Actuarial gains and losses result from increases or decreases in the present value of the defined benefit obligation because of changes in actuarial assumptions and experience adjustments.

There are different types of actuarial assumption used in determining the defined benefit obligation.

Demographic assumptions deal with matters such as:

a) Mortality;

b) Rates of employee turnover, disability, and early retirement;

c) The proportion of plan members with dependents who will be eligible for benefits;

d) The proportion of plan members who will select each form of payment option available under the plan terms; and

e) Claim rates under medical plans.

Financial assumptions deal with items such as:

a) The discount rate;

b) Benefit levels, excluding any cost of the benefits to be met by employees, and future salary;

c) In the case of medical benefits, future medical costs, including claim handling costs and

d) Taxes payable by the plan on contributions relating to service before the end of the reporting period or on benefits resulting from that service.

Causes of actuarial gains and losses include, for example:

a) Unexpectedly high or low rates of employee turnover, early retirement or mortality or of increases in salaries, benefits or medical costs;

b) The effect of changes to assumptions concerning benefit payment options;

c) The effect of changes in estimates of future employee turnover, early retirement or mortality or of increases in salaries, benefits or medical costs; and

d) The effect of changes in the discount rate.

Actuarial gains and losses do not include changes in the present value of the defined benefit obligation because of the introduction, amendment, curtailment or settlement of the defined benefit plan, or changes to the benefits payable under the defined benefit plan. Such changes result in past service cost or gains or losses on settlement.

Return on Plan Assets

Net interest on the net defined benefit liability (asset) is recognized in surplus or deficit. Because the defined benefit liability (asset) is a net figure, some of the return on plan assets is included in the net interest amount.

However, the net interest amount is calculated using the discount rate, and is therefore unlikely to be the same as the actual return on plan assets, which are measured at fair value. IPSAS 46, *Measurement*, provides guidance on measuring fair value.

The difference between the interest on plan assets included in the net interest amount and the actual return on plan assets is accounted for as part of the remeasurement of the net defined benefit liability (asset) recognized in net assets/equity.

In determining the return on plan assets, an entity deducts the costs of managing the plan assets and any tax payable by the plan itself, other than tax included in the actuarial assumptions used to measure the defined benefit obligation. Other administration costs are not deducted from the return on plan assets.

Change in the Effect of the Asset Ceiling

The asset ceiling may apply where a defined benefit plan is in surplus, i.e., it has a net defined benefit asset. Many public sector defined benefit plans have a deficit, i.e., a net defined benefit liability, and the requirements in respect of the asset ceiling will not apply.

Where a defined benefit plan has a net defined benefit asset, changes in the effect of the asset ceiling are accounted for as remeasurements as described below.

Interest on the effect of the asset ceiling is part of the total change in the effect of the asset ceiling, and is determined by multiplying the effect of the asset ceiling by the discount rate. An entity determines the effect of the asset ceiling at the start of the annual reporting period. The difference between interest on the effect of the asset ceiling and the total change in the effect of the asset ceiling is included in the remeasurement of the net defined benefit liability (asset).

Illustrative Example

	Defined Benefit Obligation	Plan Assets	Net Defined Benefit Liability
Opening Balance	**(500)**	**400**	**(100)**
Service Cost in Year	(125)		(125)
Net Interest Expense in Year	(35)	28	(7)
Remeasurements in Year	(80)	55	(25)
Closing Balance	**(740)**	**483**	**(257)**

At the start of the year, an entity's defined benefit plan has a net defined benefit liability of CU 100. The two components of the net defined benefit liability are:

a) Defined benefit obligation of CU 500 (measured at its present value); and

b) Plan assets of CU 400 (measured at fair value)

The discount rate used in measuring the defined benefit plan is 7%.

At the end of the year, the entity uses a qualified actuary to determine the present value of the defined benefit obligation, the service cost for the year, and the fair value of the plan assets at the reporting date.

The actuarial report indicates that the present value of the defined benefit obligation at the reporting date is CU 740, and that the service cost for the year us CU 125. The fair value of the plan assets at the reporting date is CU 483. Consequently, the net defined benefit liability at the reporting date is CU 257.

These amounts reflect benefits paid and contributions received in the year.

Net interest on the net defined benefit liability is calculated by applying the discount rate to the opening balance of the liability:

CU 100 * 7% = CU 7

This equates to interest expense of CU 35 on the defined benefit obligation (CU 500 * 7%) and interest revenue of CU 28 on the plan assets (CU 400 * 7%).

Remeasurements of the defined benefit obligation amount to CU 80:

(CU740 – CU 500 – CU 125 – CU 35)

The remeasurements arise from actuarial variations, and are recognized in net assets/equity.

The return on plan assets in the year is CU 83, the difference between the opening and closing balances (CU 483 – CU 400).

Of this, CU 28 has been accounted for as a component of net interest on the defined benefit liability. The balance of CU 55 (CU 83 – CU 28) is accounted for as the return on the plan assets in net assets/equity.

Plan Assets

- Plan assets comprise:
  - Assets held by a long-term employee benefit fund; and
  - Qualifying insurance policies
- Exclude unpaid contributions due from the reporting entity
- Where plan assets include qualifying insurance policies that exactly match the amount and timing of some or all of the benefits payable under the plan, the fair value of those insurance policies is deemed to be the present value of the related obligations.

Assets held by a long-term employee benefit fund are assets (other than non-transferable financial instruments issued by the reporting entity) that:

a) Are held by an entity (a fund) that is legally separate from the reporting entity and exists solely to pay or fund employee benefits; and

b) Are available to be used only to pay or fund employee benefits, are not available to the reporting entity's own creditors (even in bankruptcy), and cannot be returned to the reporting entity, unless either:

(i) The remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting entity; or

(ii) The assets are returned to the reporting entity to reimburse it for employee benefits already paid.

A qualifying insurance policy is an insurance policy issued by an insurer that is not a related party (as defined in IPSAS 20) of the reporting entity, if the proceeds of the policy:

a) Can be used only to pay or fund employee benefits under a defined benefit plan; and

b) Are not available to the reporting entity's own creditors (even in bankruptcy) and cannot be paid to the reporting entity, unless either:

(i) The proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations; or

(ii) The proceeds are returned to the reporting entity to reimburse it for employee benefits already paid.

Plan assets exclude unpaid contributions due from the reporting entity to the fund, as well as any non-transferable financial instruments issued by the entity and held by the fund.

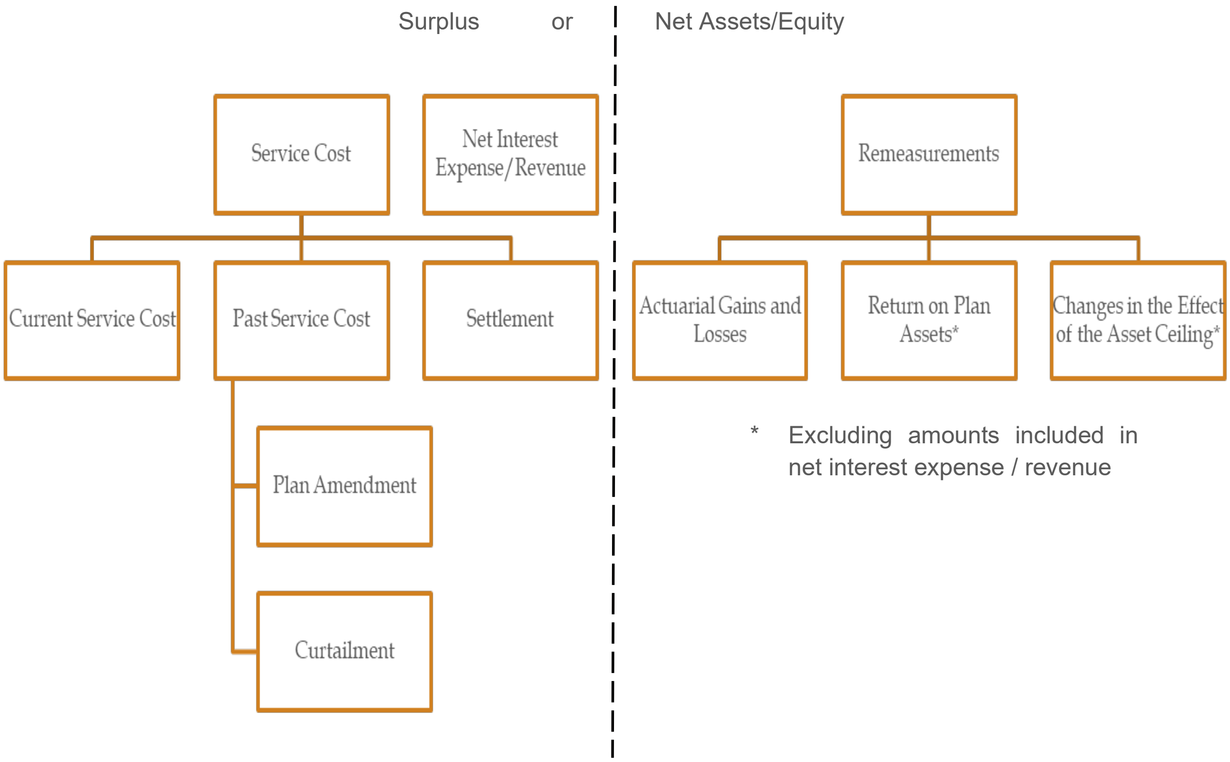
Plan assets are reduced by any liabilities of the fund that do not relate to employee benefits, for example, trade and other payables and liabilities resulting from derivative financial instruments.

Plan assets may include qualifying insurance policies.

Where plan assets include qualifying insurance policies that exactly match the amount and timing of some or all of the benefits payable under the plan, the fair value of those insurance policies is deemed to be the present value of the related obligations (subject to any reduction required if the amounts receivable under the insurance policies are not recoverable in full).

Defined Benefit Cost

The diagram illustrates the components of defined benefit cost and their presentation in the financial statements.



Presentation

- Presentation in accordance with IPSAS 1
- Assets and liabilities from different plans not offset except in specific circumstances
- Current/Non-current distinction
- Components of defined benefit costs

An entity can offset an asset relating to one plan against a liability relating to another plan when, and only when, the entity:

a) Has a legally enforceable right to use a surplus in one plan to settle obligations under the other plan; and

b) Intends either to settle the obligations on a net basis, or to realize the surplus in one plan and settle its obligation under the other plan simultaneously.

Some entities distinguish current assets and liabilities from noncurrent assets and liabilities. IPSAS 39 does not specify whether an entity should distinguish current and noncurrent portions of assets and liabilities arising from post-employment benefits.

An entity is required to recognize service cost and net interest on the net defined benefit liability (asset) in surplus or deficit. IPSAS 39 does not specify how an entity should present service cost and net interest on the net defined benefit liability (asset). An entity presents those components in accordance with IPSAS 1.

An entity presents items related to post-employment benefit plans in its financial statements in accordance with IPSAS 1. The presentation will depend on the level of aggregation that the entity applies, and the format of its financial statements (for example, whether the statement of financial performance reports expenses by function or by nature).

Further details of the presentation requirements in IPSAS 1 can be found in the Presentation module.

Disclosures

- An entity discloses information that:
  - Explains the characteristics of its defined benefit plans and risks associated with them
  - Identifies and explains the amounts in its financial statements arising from its defined benefit plans
  - Describes how its defined benefit plans may affect the amount, timing and uncertainty of the entity's future cash flows

The disclosure requirements in IPSAS 39 in respect of post-employment benefits are extensive.

Professional judgment is required in determining the disclosures to be made; IPSAS 39 identifies the following areas where judgment will be required:

a) The level of detail necessary to satisfy the disclosure requirements;

b) How much emphasis to place on each of the various requirements;

c) How much aggregation or disaggregation to undertake; and

d) Whether users of financial statements need additional information to evaluate the quantitative information disclosed.

To explain the amounts in the financial statements, an entity provides a reconciliation from the opening balance to the closing balance for each of the following, if applicable:

a) The net defined benefit liability (asset), showing separate reconciliations for:

(i) Plan assets.

(ii) The present value of the defined benefit obligation.

(iii) The effect of the asset ceiling.

b) Any reimbursement rights. An entity shall also describe the relationship between any reimbursement right and the related obligation.

Each reconciliation should show each of the following, if applicable:

a) Current service cost.

b) Interest revenue or expense.

c) Remeasurements of the net defined benefit liability (asset), showing separately:

(i) The return on plan assets, excluding amounts included in interest in (b).

(ii) Actuarial gains and losses arising from changes in demographic assumptions.

(iii) Actuarial gains and losses arising from changes in financial assumptions.

(iv) Changes in the effect of limiting a net defined benefit asset to the asset ceiling, excluding amounts included in interest in (b). An entity shall also disclose how it determined the maximum economic benefit available, i.e., whether those benefits would be in the form of refunds, reductions in future contributions or a combination of both.

d) Past service cost and gains and losses arising from settlements. Past service cost and gains and losses arising from settlements need not be distinguished if they occur together.

e) The effect of changes in foreign exchange rates.

f) Contributions to the plan, showing separately those by the employer and by plan participants.

The detailed requirements are beyond the scope of this module, and participants should refer directly to IPSAS 39 for further details.

Questions and Discussion

Visit the IPSASB webpage *http://www.ipsasb.org*

That concludes our module on employee benefits: post- employment benefits. Participants should refer to the review questions to test themselves on their knowledge.

Review Questions

Question 1

An entity recognizes a liability and expense for a defined contribution plan when an employee has rendered service:

a) At the present value of the contribution payable

b) At the amount of the contribution payable on the same basis as for short-term employee benefits

c) At the amount of the contribution payable on the same basis as for short-term employee benefits unless contributions do not fall due wholly before twelve months after the end of the period when they shall be discounted

Question 2

The accounting task for defined benefit plans is to determine:

a) To determine the amount of the funding required for the obligation for each period of employee service

b) To use an actuarial method and assumptions to determine the amount of the net defined benefit liability (asset) at the financial statement date, and the cost of the benefits earned during the period

c) Determine whether defined benefit plan assets are sufficient to meet the future settlement of the obligation

Question 3

A defined benefit plan pays a benefit of CU100 for each year of service. The benefits vest after 10 years of service, i.e., if an employee leaves before completing 10 years of service, no benefits are payable.

In applying the projected unit credit method, should the entity recognize an obligation for the employee's first year of service?

If so, how should the entity determine the current service cost and present value of the obligation?

If not, why not?

Question 4

Which of the following components of a defined benefit plan should be recognized in surplus or deficit?

a) Current service cost

b) Plan amendments

c) Return on plan assets

d) Curtailments

Answers to Review Questions

Question 1

The correct answer is (c).

Accounting for defined contribution plans is relatively straightforward because the reporting entity's obligation for each period is determined by the amounts to be contributed for that period. The obligations are measured on an undiscounted basis, except where they do not fall due wholly before twelve months after the end of the period in which the employees render the related service. Where contributions to a defined contribution plan do not fall due wholly before twelve months after the end of the period in which the employees render the related service, they shall be discounted using the procedures specified in IPSAS 39.

Question 2

The answer is (b).

The fundamental accounting task is to determine the amount of the obligation for retirement benefits to attribute to each period of employee service. Determining such amounts involves not only accounting for past transactions and events; it also requires forecasts of future events, such as inflation, investment returns, medical costs and employee turnover and mortality.

Accounting for defined benefit plans is complex, because actuarial assumptions are required to measure the obligation and the expense, and there is a possibility of actuarial gains and losses. Moreover, the obligations are measured on a discounted basis, because they may be settled many years after the employees render the related service.

Determining whether a retirement benefit plan should be funded and the amount to be funded each period is a financial management matter. The funding objective is to determine an acceptable policy for financing the estimated ultimate cost of a benefit plan.

Defined benefit plans may be unfunded, or they may be wholly or partly funded by contributions by an entity, and sometimes its employees, into an entity or fund that is legally separate from the reporting entity and from which the employee benefits are paid.

Because the objectives of determining the most appropriate funding policy are not necessarily the same as those of determining the most appropriate accounting method the expense recognized for a defined benefit plan is not necessarily the amount of the contribution due for the period.

Question 3

Employee service gives rise to an obligation under a defined benefit plan even if the benefits are conditional on future employment (in other words they are not vested). Employee service before the vesting date gives rise to a constructive obligation because, at the end of each successive reporting period, the amount of future service that an employee will have to render before becoming entitled to the benefit is reduced.

In measuring its defined benefit obligation, an entity considers the probability that some employees may not satisfy any vesting requirements.

In these circumstances, a benefit of CU100 is attributed to each year. In each of the first 10 years, the current service cost and the present value of the obligation reflect the probability that the employee may not complete 10 years of service.

Question 4

The answer is (a), (b), and (d).

Current service costs (a), past service costs and net interest on the net defined benefit liability (asset) are recognized in surplus or deficit.

Plan amendments (b) and curtailments (d) both give rise to past service costs.

The return on plan assets (c), excluding amounts included in net interest on the defined benefit liability (asset), is recognized as a remeasurement in net assets/equity.