

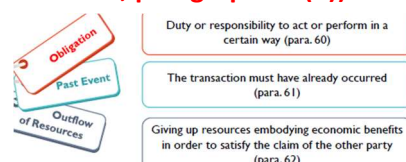
Lecture 6: Introduction to Liabilities: Provisions, Contingent Liabilities and Employee Benefits

Topic overview

- ▶ Framework definitions of liabilities
- ▶ Incentives to “adjust” liabilities
- ▶ Regulation
 - ▶ Provisions & contingent liabilities (AASB 137)
 - ▶ Employee benefits (AASB 119)

1 – Framework Definitions of Liabilities

- “A *liability* is a **present** obligation of the entity arising from **past** events, the settlement of which is expected to result in an **outflow** from the entity of resources embodying economic benefits” (AASB Framework, paragraph 49 (b))



Recognition of a Liability

- A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably (AASB Framework, paragraph 91)



2 – Incentives to “adjust” liabilities

- Liabilities represent claims on the assets of the business.
- Whilst debt is not necessarily a bad thing, high levels can be problematic:
 - If this debt is also costly (i.e. interest bearing)
 - Interest also reduces net profit
 - May impede future investment (e.g. increases riskiness)
 - Closer to breaching debt leverage covenants
- Possible actions taken:
 - No recognition or disclosure
 - No recognition, but disclosed
 - Recognised as equity, not a liability

3 – Regulation

3a– Provisions and Contingent Liabilities AASB 137

Definitions

- A **provision** is a liability of uncertain timing or amount (e.g. warranties, cleaning up contaminated land, site restoration)
- 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; or
- A present obligation that arises from past events but is not recognised because:
 - It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - The amount of the obligation **cannot be measured** with sufficient **reliability**

When to Recognise?

Provisions	Contingent liabilities	Provision recognition details	Definitions (para. 10)
▶ Shall be recognised when: <ul style="list-style-type: none"> a) The entity has a present obligation as a result of a past event; b) There is a probable outflow of resources; and c) There is a reliable estimate of the amount of the obligation □ AASB 137.14	▶ Shall not be recognised <ul style="list-style-type: none"> ▶ AASB 137.27 	▶ Present obligation <ul style="list-style-type: none"> ▶ AASB 137.15-16 ▶ The obligation can be legal or constructive ▶ Past event <ul style="list-style-type: none"> ▶ AASB 137.17-22 ▶ Creates an obligating event ▶ Identity of the other party not critical ▶ Probable outflow <ul style="list-style-type: none"> ▶ AASB 137.23-24 ▶ More likely than not to occur ▶ Reliable estimate <ul style="list-style-type: none"> ▶ AASB 137.25-26 	▶ Legal obligation <ul style="list-style-type: none"> ▶ obligation from contract, legislation or other operation of law ▶ Constructive obligation <ul style="list-style-type: none"> ▶ derived from an entity's actions that it will accept and discharge certain responsibilities ▶ Obligating event <ul style="list-style-type: none"> ▶ Is an event that creates an obligation that results in an entity having no realistic alternative to settling that obligation

Measurement

- **Provision Measurement**
 - The amount recognised as a provision shall be the **best estimate** of the expenditure required to settle the present obligation at the end of the reporting period (**AASB 137.36**)
 - Determined by the **judgment of the management** of the entity (**AASB 137.38**)
- Provision measurement details
 - If effect of TVM is material, then the present value of the amount is used (**AASB 137.45-47**)
 - Provisions reviewed annually and adjusted to reflect current best estimate (**AASB 137.59**)
 - Provisions can only be used for the expenditures set up for (**AASB 137.61**)
 - Cannot be used for future operating losses (**AASB 137.63**)

Disclosures

Disclosures – provisions	Disclosures – contingent liabilities
▶ AASB 138.84-85 <ul style="list-style-type: none"> ▶ Carrying amounts ▶ Changes to ▶ Reversals 	▶ Unless probability is remote: <ul style="list-style-type: none"> ▶ Estimate of financial effect ▶ Indication of uncertainties ▶ Possibility of any reimbursement □ AASB 138.86

3B– Employee Benefits AASB 119

- Increasing diversity in the benefits employees get
- Economically significant
 - How many people get paid in Australia
 - Qantas 2013/14 staff costs = \$3.7 billion (19.44% of total expenses)
- Key issues
 - When to recognise a liability

- When to recognise an expense
- How much to recognise

AASB 119 – Accounting for Employee Benefits

- **Scope**
 - All employee benefits with the exception of those addressed by AASB 2 Share based payment
- **Definition**
 - Employee benefits are all forms of consideration given by an entity in exchange for service rendered by employees or for the termination of employment
- **Includes:**
 - Short term employee benefits
 - Other long-term benefits
 - Termination benefits
 - Post-employment benefits (AASB 119.5)

Short Term Benefits

- Short term employee benefits are employee benefits (other than termination benefits) that are expected to be settled wholly before twelve months after the end of an annual reporting period in which the employees render the related service
- **Includes:**
 - Wages, salaries and social security contributions
 - Paid annual leave and sick leave
 - Profit sharing and bonuses
 - Non-monetary benefits for current employees
- **Recognition and Measurement:** When an employee has rendered service to an entity during an accounting period, the entity shall recognise the undiscounted amount of short term employee benefits expected to be paid in exchange for that service
 - As a liability..., after deducting any amount already paid
 - As an expense, unless another... Standard requires or permits the inclusion of the benefits in the cost of an asset (**AASB 119.11**)

▶ Short-term paid absences

- ▶ An entity shall recognise the expected cost of short-term employee benefits in the form of paid absences under paragraph 11 as follows:
 - AASB 119.13

Accumulating	Non-accumulating
<ul style="list-style-type: none"> • When the employees render service • next slide 	<ul style="list-style-type: none"> • When the absence occurs • "use it or lose it" • AASB 119.18

▶ Accumulating Short-term paid absences

- ▶ An entity shall measure the expected cost of accumulating paid absences as the additional amount that the entity expects to pay as a result of the unused entitlement that has accumulated at the end of the reporting period.
 - ▶ AASB 119.16

Vesting	Non-vesting
<ul style="list-style-type: none"> • Entitled to cash payout for any unused amount 	<ul style="list-style-type: none"> • Not entitled to cash payout for unused amount

Post-Employment Benefits

- Post-employment benefits (other than termination benefits and short term employment benefits) are benefits that are payable after the completion of employment. These include:
 - Retirement benefits (e.g. pensions, lump sum payments)
 - Other post-employment benefits (**AASB 119.26**)
- Post-employment benefits are classified as either defined contribution plans (DCP) or defined benefit plans (DBP), depending on the economic substance of the plan. (**AASB 119.27**)

DCP	DBP
<ul style="list-style-type: none"> • The entity's legal or constructive obligation is limited to the amount it agrees to contribute to the fund • Benefit received determined by contributions and investment returns • Actuarial and investment risk fall on the employee <ul style="list-style-type: none"> • AASB 119.28 	<ul style="list-style-type: none"> • The entity's obligation is provide the agreed benefits to current and former employees • Actuarial and investment risk fall on the entity <ul style="list-style-type: none"> • AASB 119.30

Recognition and Measurement

- Recognition and Measurement**
- ▶ Recognise as a **liability**..., after deducting any amount already paid.
 - ▶ Recognise as an **expense**, unless otherwise required to include as part of an asset. AASB 119.11

DCP	DBP
<ul style="list-style-type: none"> • As service is rendered (AASB 119.51) 	<ul style="list-style-type: none"> • The expense recognised is not necessarily the amount of the contribution due for the period <ul style="list-style-type: none"> • AASB 119.56 • Need to determine the entity's constructive obligation <ul style="list-style-type: none"> • AASB 119.61 • Plan assets v liabilities

Other Long-Term Benefits

- All employee benefits other than short term, post-employment and termination benefits (**AASB 119.8**)
- Includes:
 - Long term paid absences
 - Jubilee or other long service benefits
 - Long term disability benefits
 - Profit sharing and bonuses
 - Deferred remuneration- **AASB 119.153**

Recognition and Measurement

- The amount recognised as a liability for other long term employee benefits shall be the net total of the following amounts:
 - The present value of the defined benefit obligation
 - Minus the fair value on plan assets (if any)
- Recognise as an expense, unless otherwise required to include as part of an asset (**AASB 119.156**)

Termination Benefit

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

- An entity's decision to terminate an employee's employment before the normal retirement date
- An employee's decision to accept an offer of benefits in exchange for the termination of employment

Recognition and Measurement

- Recognition
 - An entity shall recognise a liability and expense for termination benefits at the earlier of the following dates
 - When the entity can no longer withdraw the offer of those benefits
 - When the entity recognises costs for restructuring that is within the scope of AASB 137 and involves the payment of termination benefits.
- Measurement
 - An entity shall measure termination benefits on initial recognition, and shall measure and recognise subsequent changes, in accordance with the nature of the employee benefit

Summary

- ▶ Liabilities represent claims on the business
- ▶ Management have incentives to manipulate liabilities
- ▶ Accounting regulation limits accounting policy choice
- ▶ The primary issues in relation to liabilities are:
 - ▶ When to recognise a liability?
 - ▶ How much to recognise a liability for?